

**THE SUITABILITY OF A SYSTEM OF GROUP TAXATION FOR
SOUTH AFRICA, WITH SPECIFIC REFERENCE TO THE
RECOMMENDATIONS OF THE KATZ COMMISSION**

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DECLARATION

I, the undersigned, do hereby declare that the work contained in this assignment is my own original work and that I have not previously in its entirety or in part submitted it at any university for a degree.

Signature:

Date: 15 November 1999

SUMMARY

The current South African tax dispensation does not make provision for a system of group taxation, which gives rise to various tax anomalies. The Katz Commission recommended the implementation of a consolidation system of group taxation in their third interim report. This study investigates the issue of group taxation with the objective of commenting on the Katz Commission's recommendation.

Chapter 1 explains the purpose of a system of group taxation and discusses the different forms of group taxation. Furthermore, the theoretical norms or canons are described which can be used to evaluate the current tax treatment of groups as well as the different forms of group taxation.

Chapter 2 investigates the current tax treatment of groups by focussing on the tax implications of various intra-group transactions. It is found that the current tax treatment of groups does not satisfy the canons of equity, neutrality, efficiency of tax collection, low administration cost and certainty. Although the absence of a system of group taxation may contribute to technical simplicity, such an absence also leads to complex tax schemes that attempt to exploit favourable tax anomalies or avoid unfavourable anomalies.

Chapter 3 examines certain issues which may render a system of group taxation unnecessary or undesirable, even if such a system leads to better compliance with the canons of taxation. The conclusion is reached that none of these issues will cause such a result. With regard to the issue of divisionalisation as an alternative to group taxation, it is found that section 39 of the Taxation Laws Amendment, No. 20 of 1994 does not provide an accessible mechanism for divisionalisation. Furthermore, groups may be preferred over divisionalised companies for various commercial and legal reasons. With regard to the issue of limited liability of individual group companies (a benefit which is not available to individual divisions of a single company) it is found that group companies rarely abuse this benefit. In addition, a system of group taxation will complement the concept of limited liability in promoting economic growth. With regard to the issue of concentration of economic control and ownership, the

conclusion is reached that group taxation will not lead to further concentration of economic control, as the intra-group shareholding required for group tax treatment will greatly exceed the intra-group shareholding necessary for economic control. A system of group taxation may even lead to the broadening of economic ownership by enabling minority shareholdings in group companies which would otherwise be structured as divisions of existing companies due to tax considerations.

Chapter 4 compares the loss transfer system of group taxation with the consolidation system, using the canons of taxation as a reference framework. Because a loss transfer system is similar to the current tax treatment of groups, in the sense that both dispensations treat individual group companies as separate taxable entities, the current tax treatment of groups is included in the above mentioned comparison by implication. It is found that a consolidation system will satisfy the canons of taxation the best. Although such a system carries the risk of undue complexity, it should be possible to design and implement a specific system which will fall within the administrative capabilities of both taxpayers and tax authorities.

Chapter 5 examines key recommendations of the Katz commission with regard to group taxation. The writer expresses his agreement with the commission's conclusion that a consolidation system of group taxation should be implemented gradually. Certain adjustments to the commission's recommendations are suggested, which will facilitate quicker implementation and increased simplicity.

The current tax treatment of groups leads to tax anomalies which are highly unsatisfactory. From a theoretical as well as a practical perspective, the implementation of a consolidation system of group taxation will represent a significant improvement to the South African tax dispensation.

OPSOMMING

Suid-Afrika beskik tans nie oor 'n stelsel van groepbelasting nie, wat aanleiding gee tot verskeie belastinganomalieë. Die Katz-kommissie het die implementering van 'n gekonsolideerde stelsel van groepbelasting aanbeveel in hulle derde tussentydse verslag. Hierdie studie ondersoek die aangeleentheid van groepbelasting met die doel om kommentaar te lewer op die Katz-kommissie se voorstelle in hierdie verband.

In Hoofstuk 1 word die doel van 'n stelsel van groepbelasting verduidelik, en die verskillende vorme van groepbelasting bespreek. Verder word die teoretiese norme beskryf waaraan die huidige belastinghantering van groepe en die verskillende vorme van groepbelasting gemeet kan word.

In Hoofstuk 2 word die huidige belastinghantering van groepe ondersoek deur te fokus op die belastingimplikasies van 'n verskeidenheid intra-groep transaksies. Dit word bevind dat die huidige belastinghantering van groepe nie lei tot billikheid, neutraliteit, effektiewe invordering van die belastinglas, lae administrasiekoste en sekerheid nie. En alhoewel die gebrek aan 'n stelsel van groepbelasting bydra tot tegniese eenvoud, lei dit terselfdetyd tot ingewikkelde, belastinggedrewe skemas wat poog om gunstige belastinganomalieë te benut en om ongunstige belastinganomalieë te vermy.

In Hoofstuk 3 word sekere aangeleenthede ondersoek wat moontlik 'n stelsel van groepbelasting onnodig of onwenslik sal maak, selfs al sou so 'n stelsel lei tot 'n meer gebalanseerde bevrediging van die teoretiese belastingnorme. Die slotsom word bereik dat geeneen van hierdie aangeleenthede wel so 'n resultaat sal hê nie. Met betrekking tot divisionalisering as 'n alternatief vir groepbelasting, word beslis dat artikel 39 van die Wysigingswet op Belastingwette, No. 20 van 1994 nie 'n toeganklike meganisme daarstel vir die divisionalisering van bestaande groepe nie. Uit 'n kommersiële en regsoogpunt bestaan daar boonop verskeie redes waarom groepe bo gedivisionaliseerde maatskappye verkies word. Met betrekking tot die beperkte aanspreeklikheid van afsonderlike groepmaatskappye ('n voordeel wat nie tot die beskikking is van divisies van 'n enkele maatskappy nie), word bevind dat groepe in praktyk selde hierdie voordeel misbruik of selfs benut. Voorts sal 'n stelsel van

groepbelasting die konsep van beperkte aanspreeklikheid komplementeer in die bevordering van ekonomiese groei. Met betrekking tot die konsentrasie van ekonomiese beheer en eienaarskap, word beslis dat 'n stelsel van groepbelasting nie die verdere konsentrasie van ekonomiese beheer sal aanhelp nie, aangesien die kwalifiserende aandeelhouding wat vir groepbelastinghantering vereis sal word, die aandeelhouding wat nodig is vir ekonomiese beheer ver sal oorskry. 'n Stelsel van groepbelasting mag voorts bydra tot die verbreding van aandeel-eienaarskap, deurdat buiteaandeelhouders direkte belange sal kan opneem in ondernemings wat andersins gestruktureer sou word as divisies van bestaande maatskappye.

In Hoofstuk 4 word verliesoordragstelsels en gekonsolideerde stelsels van groepbelasting in die algemeen vergelyk, met die belastingnorme as 'n verwysingsraamwerk. Aangesien 'n verliesoordragstelsel soortgelyk is aan die huidige belastinghantering van groepe, in die sin dat albei bedelings groepmaatskappye as afsonderlike belastingentiteite hanteer, word die huidige belastinghantering van groepe by implikasie ingesluit in die vergelyking. Die slotsom word bereik dat 'n gekonsolideerde stelsel van groepbelasting die mees bevredigende stelsel is in terme van 'n gebalanseerde voldoening aan die belastingnorme. Alhoewel 'n gekonsolideerde stelsel die risiko van kompleksiteit inhou, is dit moontlik om 'n spesifieke stelsel op sodanige wyse te ontwerp en implementeer dat dit wel administreerbaar sal wees.

In Hoofstuk 5 word sleutelaanbevelings van die Katz-kommissie met betrekking tot groepbelasting ondersoek. Die skrywer spreek sy instemming uit met die kommissie se voorstelle vir die geleidelike implementering van 'n gekonsolideerde stelsel van groepbelasting. Sekere wysigings word aangebring aan die kommissie se voorstelle, ten einde verdere eenvoud en spoediger implementering teweeg te bring.

Wanneer die belastinganomalieë as gevolg van die huidige belastinghantering van groepe oorweeg word, is dit duidelik dat die huidige situasie onhoudbaar is. Uit 'n teoretiese en praktiese oogpunt, sal die implementering van 'n gekonsolideerde stelsel van groepbelasting 'n beduidende verbetering van die Suid-Afrikaanse belastingbedeling meebring.

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1 PURPOSE AND SCOPE OF STUDY

1.1 INTRODUCTION

At present South Africa does not have a system of group taxation – each company within a group is treated as a separate taxpayer. In this regard South Africa is out of step with the tax treatment of groups in most industrialised countries (South Africa, 1995: 96).

The issue of group taxation has been considered frequently in the past. Several articles were published in local business and legal periodicals, arguing in favour of group taxation. The Margo Commission investigated the matter and recommended that a system of group taxation should not be introduced in South Africa. However, the recommendation of that commission was met with widespread criticism in academic and business circles. The matter of group taxation was again examined by the Katz Commission, which expressed the following opinion: “The Commission is mindful of the view amongst some that the issue of group taxation is not a priority. It disagrees with this view, and regards the current position as a structural defect in the system that cannot be passed over in any serious tax reform process” (South Africa, 1995: 96).

This study will examine the issue of group taxation in the South African context, with the objective of commenting on the Katz Commission’s findings and recommendations in this regard.

1.2 DEFINING GROUPS

1.2.1 Introduction

The debate in South Africa about group taxation still revolves around the question of its desirability in principle. As the debate has not yet progressed to the detailed design of a system of group taxation, no attempt will be made in this study to formulate a precise technical definition of groups. Rather, certain issues will be identified which must be considered when constructing such a definition.

1.2.2 The nature of groups

A closely held group, although consisting of individual companies, each with a separate legal persona, may nevertheless constitute a single economic entity for purposes of strategic management and financial planning (South Africa: 1995, 96). Because of the control over subsidiaries inherent in a group structure, the group's activities are directed in the interest of the group as a whole, rather than in the interest of individual group members. Inevitably, the question arises whether it is appropriate to split this single economic unit into various tax units.

In economic substance a closely held group is very similar to a divisionalised company. Yet vastly different tax results may be obtained by employing these legal structures as alternatives. A system of group taxation addresses this anomaly by treating closely held groups in a similar fashion to divisionalised companies, thereby establishing a tax regime that more closely adheres to the theoretical principles of taxation.

1.2.3 The definition of groups in the Companies Act and its suitability with regard to a system of group taxation

The definitions of holding companies and subsidiaries (which together constitute groups) in section one of the Companies Act (1973) are based on control of business enterprises rather than on substantial ownership thereof. In terms of the definitions, one company can be the holding company of another without owning the majority of equity shares in that company. This can be achieved, for example, by merely being a member of that company and possessing the right to appoint or dismiss directors that hold the majority of voting rights at its directors' meetings.

A definition of groups based on control, such as contained in the Companies Act, is inappropriate for the purposes of group taxation if one bears in mind that the main aim of such a system is to achieve similar tax results between closely held groups and divisionalised companies. Rather, the definition of groups should embrace the concept of substantial intra-group ownership. In other countries where group tax regimes exist, the required ownership interest varies from 66% in New

Zealand, 75% in the United Kingdom, 80% in the United States of America to 100% in Australia and the Netherlands.

Given the South African sensitivity towards concentration of economic power, a system that requires 100% ownership within the group might not be acceptable. Minority shareholders should be accommodated within a group tax regime; however, to align groups with divisionalised companies, a minimum intra-group interest of 75% should be prescribed. In this way the holding company can single-handedly pass special resolutions, which will enable it to manage the subsidiary in much the same fashion as a division. Furthermore, a stake of 75% in the subsidiary would be substantial enough to qualify the holding company conceptually as the effective owner of the subsidiary's business.

1.2.4 The measure of ownership

A critical matter that must be considered is which variable or variables will serve as a measure of ownership. Measures of ownership differ in foreign tax jurisdictions. Some of the variables employed include:

- percentage of voting power held;
- percentage of entitlement to profit distributions;
- percentage of entitlement to capital distributions on liquidation;
- percentage of total market value of all equity instruments held; and
- a combination of the above (Australia: 1977, 19).

A decision on the appropriate measure for a South African system of group taxation is beyond the scope of this study. Nevertheless, it must be emphasised that the measure selected must be an effective reflection of ownership of the particular enterprise.

1.2.5 Calculation of the required intra-group ownership interest

Another matter that should be examined is the way in which intra-group interests will be calculated in the case of complex groups. Two methods will be illustrated by employing the following hypothetical information: Holdco holds 75% of the shares in Subco1, while Subco1 owns 75% of the shares in Subco2. The required intra-group ownership interest for group tax treatment is 75%.

The first method requires that the ultimate holding company's effective interest in a subsidiary must be 75%. According to this method, Holdco and Subco1 constitute a group, while Subco1 and Subco2 constitute a separate group. Subco2 cannot be included in a group with Holdco as Holdco's effective interest in Subco2 is only 56.25% ($75\% \times 75\%$).

The second method merely requires that the outside shareholding of each group member (that is, excluding the shareholdings of direct and indirect holding companies) does not exceed 25%. According to this method Holdco, Subco1 and Subco2 will constitute a single group.

The first alternative prevents group tax treatment in instances where the effective interest of an ultimate holding company in a subsidiary is too small to justify viewing the subsidiary conceptually as a division of the holding company. The second alternative avoids excessive elimination of minorities in order to qualify for group tax treatment. Whichever method is selected will depend on a consideration of policy issues unique to each tax jurisdiction.

1.2.6 Treatment of close corporations

A final question that must be addressed is whether a group tax regime should be extended to close corporations. It is the writer's opinion that a system of group tax must be restricted to companies for three reasons.

Firstly, close corporations were devised as vehicles for small, relatively simple enterprises. It is therefore unlikely that these corporate vehicles will feature in inherently complex group structures - the domain of group tax systems.

Secondly, according to section 29 of the Close Corporations Act legal persons are disallowed from being members of close corporations, thereby preventing close corporations from being subsidiaries within groups. (It should be noted that a close corporation may hold an interest in a company and can therefore act as a holding entity. The resulting group will most probably not be vast and complex, due to the relative smallness and simplicity of the holding entity. The application of a group tax system to such a group would therefore be inappropriate.)

Finally, the Close Corporations Act imposes fewer controls on close corporations than the Companies Act does on companies. Disclosure requirements are not as onerous and a statutory audit is not required. One would prefer to introduce a group tax regime, being fairly sophisticated in nature, into an environment that is more controlled than that of close corporations.

1.3 THE CONCEPT OF GROUP TAXATION

1.3.1 Countering anomalies

When a single economic entity is treated as several tax entities, certain anomalies are inevitable. The most important anomaly arises when a group collectively earns no profit or even suffers a loss, but has to pay tax on the income of profitable companies within the group. Assume the following information: Holdco, which has income of R100 for a certain year of assessment, owns 100% of the shares of Subco, which has an assessed loss of R100 for that year. The group as such has earned no profit for the year. Yet because Holdco and Subco are regarded as separate tax entities, Holdco must pay tax of R30 (assuming a corporate tax rate of 30%), while Subco may only carry forward its assessed loss to the succeeding year of assessment. Although Subco may possibly utilise the assessed loss in future, there is a distinct cash flow disadvantage in the current period, as tax of R30 must be paid on an effective group profit of R0. This situation would never have arisen if the business operations of the group were conducted through the medium of a

single company. Thus, by merely changing the legal form of the enterprise without altering its economic substance, dramatically different tax effects can be achieved.

Other intra-group anomalies that will be examined in Chapter 2 are timing differences between taxable and deductible amounts, capital/revenue mismatches and the manipulation of cost bases. Sometimes these anomalies are to the disadvantage of taxpayers, but often they are deliberately engineered by taxpayers to avoid, reduce or postpone liability for tax. A group tax regime counters the above-mentioned anomalies by reconciling substance with form through the alignment of tax entities with economic entities.

1.3.2 Forms of group taxation

Three different forms of group taxation can be distinguished, namely consolidation systems, loss transfer systems and subvention payment systems.

1.3.2.1 Consolidation systems

A consolidation system is the most satisfactory system conceptually, because it truly addresses the groups as the relevant taxable entities. Intra-group transactions are disregarded when calculating group taxable income, and only transactions with parties outside the group have tax consequences. The tax result of a group of companies will therefore be similar to the result that would have been achieved if it had been a single company with a number of separate divisions (Lugtenburg, 1990: 8).

1.3.2.2 Loss transfer systems

A loss transfer system counters the main anomaly mentioned in section 1.3.1, namely that a group which collectively earns no profit or even suffers a loss during a particular year must pay tax because individual group members are profitable. As the name of the system indicates, group members with assessed losses are allowed to transfer such losses to group members with taxable

income. Compensation paid between members for the transfer of losses is disregarded for tax purposes (Lugtenburg, 1990: 8).

The operation of such a system can be illustrated by the following example. Holdco holds 75% of the shares of Subco. Holdco earns taxable income of R100 in a certain year of assessment while Subco suffers an assessed loss of R100. Subco may transfer its loss to Holdco, and Holdco may deduct the loss from its own taxable income. Consequently, Holdco will pay no tax in that year of assessment, while Subco will not be entitled to carry forward the assessed loss to the succeeding year of assessment. To prevent minority shareholders in Subco from being prejudiced by the transfer of the assessed loss, Holdco can pay compensation to Subco equal to the amount of tax saved because of the loss transfer, namely R30 ($R100 * 30\%$). (As an additional refinement, the amount of compensation can be determined as the expected present value of the tax saving if the assessed loss were to be utilised by Subco in a future year or years of assessment.)

Group profit attributable to shareholders of Holdco amounts to R25 ($R100 - R100 * 75\%$). The effective loss to Holdco shareholders in respect of compensation paid to Subco equals R7.50 ($-R30 + R30 * 75\%$), which amounts to 30% of their attributable profit of R25. Minority shareholders in Subco are entitled to R7.50 ($R30 * 25\%$) of the compensation, which equals 30% of their share of Subco's loss, amounting to R25 ($R100 * 25\%$).

A loss transfer system therefore allows the immediate utilisation of assessed losses within the group. This ensures that no anomalous tax cash flows occur because of the carry-forward and future utilisation of such losses by individual group members.

1.3.2.3 Subvention payment systems

The operation of a subvention payment system is similar to that of loss transfer system, but with one important distinction. A loss transfer system allows the transfer of the loss itself, and compensation paid for and received by group members because of the loss transfer does not have any tax effects. In a subvention payment system, a payment is made between group members, which is deductible by the payer and taxable in the hands of the receiver (Lugtenburg, 1990: 8).

Thus the payment serves to induce the tax effect and is not merely compensation for the transfer of the tax effect. In reality, a subvention payment is a subsidy from a profitable group member to a loss-making group member that attracts tax consequences.

The problem with the making of subvention payments is that, where minority shareholdings exist within group structures, value will be transferred without the receipt of a commensurate *quid pro quo* (Wroth, 1982: 16). The reader is referred to the example in the second paragraph of section 1.3.2.2 of Holdco and its 75% owned subsidiary, Subco. Assume that Holdco makes a subvention payment of R100 to Subco, instead of Subco transferring its assessed loss of R100 to Holdco. As both companies now have taxable income of R0, no tax will be paid by any of the group companies. Group profit attributable to shareholders of Holdco equals R0, and minority shareholders of Subco are similarly entitled to a profit share of R0. When this situation is compared with the situation in section 1.3.2.2, it becomes clear that value of R25 has been transferred from Holdco shareholders to minority shareholders in Subco without any commercial justification. This causes subvention payment systems seldom to be employed in practice. Consequently, they will not be examined further in this study. Significantly, the Katz Commission also did not consider subvention payment systems.

1.3.3 Group taxation and minority shareholdings in subsidiaries

The fundamental reason for a system of group taxation is that it brings tax entities and economic entities into alignment. However, the presence of minority shareholders within a closely held group potentially creates a problem. Although such a group clearly constitutes a single economic entity, the existence of separate and distinct ownership interests cannot be denied.

Consider the example of a holding company, Holdco, which holds 75% of the shares in a subsidiary company, Subco. The extent of Holdco's shareholding in Subco clearly leads to the conclusion that the group, and not the individual companies, is the economic unit. Nevertheless, two different ownership interests can be identified. The first ownership interest is the shareholders of Holdco, who participate in 100% of the assets and profits of Holdco and in 75% of the assets and profits and of Subco (through Holdco's shareholding in Subco). The second

ownership interest is the minority shareholders in Subco, who participate in 25% of the assets and profits of Subco. The question may be asked whether a group tax system which treats the Holdco group as a single economic entity will not prejudice the minority shareholders of Subco by disregarding them as a separate ownership interest.

With regard to loss transfer systems, the example discussed in section 1.3.2.2 clearly illustrates how the payment of compensation for the transfer of assessed losses between group companies will prevent unfair treatment of minority shareholders in group subsidiaries.

With regard to consolidation systems, it is possible to devise methods for the allocation of the total group tax liability between individual group companies which will not systematically prejudice minority shareholders of group subsidiaries. For example, the following alternative allocation methods, based on the consolidation system operative in the United States of America, may be employed:

- The tax liability of the group can be proportionally allocated to individual group companies on the basis of the contribution of each company to the consolidated taxable income.
- The total tax liability of the group can be determined as if there is no consolidated return. The ratio which the tax liability of each group member, calculated in this manner, bears to the total unconsolidated tax liability is then applied to the actual consolidated tax liability.
- The group tax liability can be allocated according to any other method which is approved by the Revenue Service (Hurst & Stermer, 1994: 21).

Under the above-mentioned allocation system, a group qualifying for consolidated group tax treatment will be allowed to elect the specific allocation method applicable to it.

The first two methods will achieve a reasonable allocation of the group tax liability between the individual group companies. This does not necessarily imply that the allocation will result in different ownership interests bearing the exact tax charge that they would have borne if individual group companies were taxed separately. Consider once again the example of the group consisting of Holdco and its 75% held subsidiary, Subco. Assume that Holdco earns taxable income of R200 in both years 1 and 2, while Subco earns taxable income of R100 during each of

such years. In arriving at the taxable of Subco for year 1, a loss of R20 on the sale of stock to Holdco has been deducted. None of this stock is sold by Holdco during year 1, giving rise to an unrealised loss of R20 from a group perspective. All of the stock is sold by Holdco during year 2, causing the previously unrealised loss of R20 to be realised from a group perspective.

The consolidated taxable income of the group for year 1 is R320 ($R200 + R100 + R20$). Assuming a tax rate of 30%, the consolidated tax liability amounts to R96 ($R320 * 30\%$). If the consolidated liability is allocated to the individual group companies on the basis of their contribution to the consolidated taxable income, Holdco will incur a liability of R60 [$R200 / (R200 + R100 + R20) * R96$], while Subco will incur a liability of R36 [$(R100 + R20) / (R200 + R100 + R20) * R96$]. The tax charge borne by the shareholders of Holdco (as one of the two distinct ownership interests) will equal R87 ($R60 + R36 * 75\%$), while the tax charge borne by the minority shareholders in Subco will equal R9 ($R36 * 25\%$).

If the group companies were taxed separately, Holdco's taxable income and tax charge would be R200 and R60 respectively, while the corresponding amounts for Subco would be R100 and R30. The tax charge borne by the shareholders of Holdco would amount to R82.50 ($R60 + R30 * 75\%$), and the charge borne by minority shareholders in Subco would equal R7.50 ($R30 * 25\%$).

Under the consolidation system the shareholders of Holdco incur an additional tax charge of R4.50 ($R87.00 - R82.50$) during year 1, which represents their share of the tax on the unrealised profit ($R20 * 30\% * 75\%$). The minority shareholders of Subco incur an additional charge of R1.50 ($R9.00 - R7.50$), which similarly represents their portion of the tax on the unrealised profit ($R20 * 30\% * 25\%$).

It can be demonstrated that the consolidation system results in a year 2 tax charge which is reduced by R4.50 and R1.50 for Holdco shareholders and Subco minority shareholders respectively. This is because of the subsequent realisation of the loss of R20 outside the group.

Although the cumulative tax effect for the different ownership interests over the two-year period is the same, whether a consolidation system is employed or not, timing differences exist within

this period. Minority shareholders in Subco are prejudiced to a certain extent, as they incur a loss of R5 ($R20 * 25\%$) during year 1 arising from a transaction with a separate and distinct ownership interest, for which tax relief is delayed until year 2. However, it can be argued that in cases where Subco profitably sells stock to Holdco, the minority shareholders in Subco will benefit from the fact that taxation of such profits will effectively be delayed until the profits are realised outside the group.

Furthermore, instead of allocating the group tax liability on the basis of the individual companies' contribution to the consolidated taxable income, the group can opt for a unique method approved by the Revenue Service, which will place minority shareholders of subsidiaries in the position that they would have been in if the group companies were taxed separately. Thus, R30 of the group tax liability in both years 1 and 2 can be allocated to Subco. This causes the minority shareholders of Subco to incur a yearly tax charge of R7.50 ($R30 * 25\%$), which is equal to the tax charge which they would have borne if Subco was taxed separately. The remaining R66 ($R96 - R30$) of the group tax liability during year 1 will be allocated to Holdco, resulting in a tax charge of R88.50 ($R66 + R30 * 75\%$) being incurred by Holdco shareholders. In effect Holdco shareholders will assume an additional charge of R1.50 ($R88.50 - R87.00$) in year 1 to compensate the minority shareholders of Subco for the consolidation system's disregard of separate ownership interests. Note that the year 2 tax charge borne by Holdco shareholders will be reduced by a commensurate amount, as they will receive the tax benefit of Subco minorities' portion of the now realised loss in return for accepting the full tax charge relating to the reversal of the unrealised loss during year 1. Shareholders in Holdco may be content to endure what is essentially a timing disadvantage so that the other advantages of a consolidation system can be enjoyed.

Finally, in the absence of a system of group taxation, groups may shift income between individual group companies to accelerate the utilisation of assessed losses. Where the transactions through which income shifting is effected have scant economic rationale, the unjustified intra-group transfer of value will represent a far greater prejudice to certain ownership interests.

1.4 CANONS OF TAXATION

1.4.1 Introduction

The canons of taxation are the general principles to which any system of taxation should adhere. These canons establish a theoretical ideal that will seldom be fully attained in practice (Van Schalkwyk, 1997: 7). Nevertheless, they provide a measure by which the shortcomings of an existing tax system can be identified, and by which proposals for reform can be evaluated. It is therefore necessary to elaborate briefly on the canons of taxation, as they will be employed to decide whether the present lack of a group tax regime in South Africa is tenable, and if not, to determine a form of group taxation that is suitable to our circumstances.

Many classifications of the canons of taxation have been attempted. For the purpose of this work, the following canons will be referred to:

- equity;
- neutrality;
- efficiency of collection;
- administrative cost; and
- simplicity and certainty.

1.4.2 Equity

Equity refers to the distribution of the tax burden – each taxpayer should pay his fair share. Two notions of equity exist, namely the benefit principle and the principle of ability to pay. Following the first principle, taxes should be levied in accordance with the value of public goods and services received by taxpayers. Following the second principle, taxes should be levied in accordance with the economic well-being of taxpayers. The latter principle is widely regarded as being more equitable than the former, and consequently most taxes are levied according to it (South Africa, 1987: 51).

In addressing the question of ability to pay, it is customary to distinguish between horizontal and vertical equity. Horizontal equity requires that persons in the same situation be treated equally, while vertical equity requires that those in different circumstances bear appropriately different tax burdens (South Africa, 1987: 51). For the purpose of this study horizontal equity is particularly relevant, in the sense that a closely held group, which can be viewed as a single economic entity, should be treated in the same way as a divisionalised company. Our tax jurisdiction, however, often achieves exactly the opposite result by treating individual companies within a group as separate taxable entities.

1.4.3 Neutrality

Neutrality requires that people should not be influenced by the tax system to choose one course of action rather than another, solely or predominantly because their tax position is better under one of the options (South Africa, 1987: 50). Tax should not act as an artificial incentive to change business practices. If it does, the result will be reduced output and a less efficient use of resources (Stoltz, 1987: 30).

A tax jurisdiction that does not recognize a closely held group as a single tax entity may jeopardize neutrality. The reason for this is that transactions between individual group members will have tax effects, although they essentially occur within the same economic unit. Transactions between group members often do not have to be executed at arm's length, because their economic interests do not conflict. Consequently, intra-group transactions may be motivated by opportunities for tax avoidance instead of other commercial reasons. Conversely, otherwise commercially sound intra-group transactions may not be entered into because of the adverse tax effect that they will have from a group perspective.

1.4.4 Efficiency of collection

A taxation system is efficient if it succeeds in collecting the intended tax burden. To be efficient, the system should be reasonably equitable to ensure the loyalty and cooperation of

taxpayers (Stoltz, 1987: 30). Another requirement for an effective system is that it should not over-extend the administrative capacity of the tax authorities. Where this capacity is already strained, as is the case in South Africa, the system must be simple to administer.

1.4.5 Administrative cost

The matter of administrative cost should be considered in relation to the tax authorities as well as taxpayers. With regard to the tax authorities, administration costs are incurred in establishing and maintaining collection agencies and in dealing with offenders. With regard to taxpayers, costs are incurred in complying with the system and in optimising tax positions (South Africa, 1987: 51).

The administrative cost of a system of taxation should be minimised as far as possible. As Adam Smith stated: “Every tax ought to be so contrived as to take out and keep out of the pockets of the people as little as possible over and above what it brings in to the public treasury of state” (Stoltz, 1987: 36). However, a fine balance must be maintained between administration costs on the one hand and effectiveness on the other. If too few resources are devoted to the proper collection of taxes, avoidance will most likely increase, thereby reducing effectiveness (Stoltz, 1987: 36).

1.4.6 Simplicity and certainty

Taxes should be certain and simple both in concept and collection. Simplicity requires that a tax should be easily assessed, collected and administered. The more complex a tax system, the greater the administrative cost. Certainty requires that a taxpayer should not be in doubt of his tax liability in any given set of circumstances. Uncertainty results in additional compliance costs by way of consultation fees to tax advisers and litigation costs. Furthermore, uncertainty may cause the delay or cancellation of potential business transactions (South Africa, 1987: 51).

A balance needs to be struck between simplicity and certainty. On the one hand, it is necessary that rules and procedures should be as simple as possible. On the other hand, the ideal of

certainty often demands that many components of the tax system be codified in laws and regulations of inevitable complexity (South Africa, 1994: 10)

1.4.7 Interdependencies and conflicts between the canons of taxation

From the above discussion of the different canons, it is clear that several interdependencies exist between them. These interrelationships often result in a blurring between the individual canons to the extent that any distinction between them appears artificial. Nevertheless, the distinction is necessary to facilitate rigorous and disciplined analysis.

Several conflicts between the different canons are also evident. Compromises must inevitably be made between these conflicts, and consequently the design of an ideal system is virtually impossible. To compound the above-mentioned problem, there is no objective set of rules for determining how the compromises should be made. Rather, trade-offs are determined by a host of economic, political and social factors unique to each tax jurisdiction. As a result the whole process of tax reform becomes immensely challenging.

1.5 PURPOSE, METHOD AND SCOPE OF THE STUDY

1.5.1 Purpose

The purpose of this study is to evaluate the desirability of a system of group taxation in South Africa against the background of the canons of taxation, with the objective of commenting on the key proposals of the Katz Commission in this regard.

In Chapter 2 the present tax treatment of South African groups is investigated. The focus falls on the tax effects of intra-group transactions, as this aspect differentiates groups from divisionalised companies. Relevant provisions of the South African Income Tax Act are examined. Court cases dealing with the tax effects of intra-group transactions are elaborated upon. Finally, the canons of

taxation are employed to evaluate the *status quo*, and the conclusion is drawn that the present lack of group taxation creates a highly unsatisfactory situation.

In Chapter 3, three diverse policy issues are examined. Firstly, divisionalisation is discussed as a viable alternative to group taxation for avoiding the tax anomalies caused by the present tax treatment of groups. Secondly, the chapter investigates whether a system of group taxation can be justified in the light of the limited liability of individual companies, bearing in mind that divisions of a single company do not enjoy a similar benefit. Finally, the possibility that a system of group taxation will encourage concentration of economic control and ownership is examined.

In Chapter 4 consolidation systems are compared with loss transfer systems, by employing the canons of taxation as a theoretical framework. It is concluded that a consolidation system of group taxation represents a more satisfactory trade-off between the canons than a loss transfer system or the *status quo*.

Chapter 5 summarises the proposals of the Katz Commission concerning group taxation and evaluates these proposals with reference to the conclusions reached in Chapter 4.

Chapter 6 is devoted to a general summary of the study and a conclusion.

1.5.2 Method

The method followed in this work is that of a literature study. Literature consulted includes local and foreign tax legislation, textbooks, studies undertaken by overseas research institutions and local commissions, articles published in legal and business periodicals and relevant court cases. In addition, interviews were conducted with members of the subcommittee of the Katz Commission concerned with group taxation. Minutes of their meetings were also consulted.

1.5.3 Scope

The scope of this study is limited in two ways.

Firstly, the issue of group tax will only be addressed on a conceptual level, with the focus being on broad principles and policy issues instead of the detailed design and implementation of a specific system for South Africa. Although the Katz Commission is in favour of group taxation, the government has not yet responded to its recommendation. Significantly, the South African Revenue Service is very sceptical towards group taxation. As consensus has not yet been reached about the desirability of such a system for South Africa, it would be pointless to elevate the debate to the level of detailed design and implementation at this stage.

Secondly, the types of tax that will be considered are limited to normal tax and secondary tax on companies.

1.6 SUMMARY

Chapter 1 established the building blocks necessary for developing the arguments contained in the following chapters. The concept of groups was examined and the purpose and forms of group taxation were explained. Furthermore, the canons of taxation were discussed as they will serve as a tool for evaluation of the *status quo* and the proposals for reform. Finally, the purpose, method and scope of this work were set out.

2 PRESENT TAX TREATMENT OF GROUPS

2.1 INTRODUCTION

Transactions between different divisions of the same company do not have tax effects, because the company, instead of its divisions, is treated as the taxable entity. On the other hand, transactions between different group companies do have tax effects, because the individual companies, instead of the group, are treated as the taxable entities. This chapter will examine the tax effects of certain intra-group transactions and will evaluate the impact of such tax effects on the canons of taxation.

2.2 GENERAL INCOME/EXPENDITURE

2.2.1 Introduction

For the purposes of this work, general income/expenditure transactions refer to those transactions where the separate legs are recorded for accounting purposes as income and expenditure respectively. In addition, the inclusion of the income leg of such transactions in gross income is governed by the general definition of gross income in section 1 of the South African Income Tax Act (1962), hereafter referred to as “the Act”. Finally, the deduction of the expenditure leg is governed by section 11(a), the general deduction formula, and section 23(g), which prohibits the deduction of non-trade expenditure. Examples of general income/expenditure transactions are intra-group interest, rentals and management fees.

Various anomalies can occur with regard to general income/expenditure transactions. Such anomalies can be categorised as:

- timing mismatches;
- taxability/deductibility mismatches due to the non-satisfaction of certain requirements of sections 11(a) and 23(g) that are not echoed in the general definition of gross income; and
- taxability/deductibility mismatches due to capital/revenue differences.

2.2.2 Relevant sections of the Act

2.2.2.1 Section 1 - the general definition of gross income

The general definition of gross income in section 1 of the Act states that “gross income, in relation to any year of assessment, means, in the case of any person, the total amount, in cash or otherwise, received by or accrued to or in favour of such a person during such year or period of assessment from a source within or deemed to be within the Republic, excluding receipts or accruals of a capital nature...” Thus, before an amount, in cash or otherwise, can be included in a person’s gross income, it must satisfy all of the following restrictive requirements:

- The amount must be received by or have accrued to the person during the year of assessment in which it is to be included.
- The amount must be from a source within or deemed to be within the Republic.
- The amount may not be of a capital nature.

2.2.2.2 Section 11(a) - the general deduction formula

Section 11(a) of the Act states that “for the purpose of determining the taxable income derived by any person from carrying on any trade within the Republic, there shall be allowed as deductions from the income of such person so derived, expenditure and losses actually incurred in the Republic in the production of the income, provided such expenditure and losses are not of a capital nature.” Thus, before expenditure or losses can be deducted, they must satisfy the following restrictive requirements:

- The expenditure or losses must be actually incurred.
- The expenditure and losses must be in the production of income derived from any trade carried on in the Republic.
- The expenditure and losses may not be of a capital nature.

Although not specifically required by section 11(a), it was determined in *Concentra (Pty) Ltd v CIR* (1942) that expenditure or losses can only be deducted in the particular year of assessment in which they were actually incurred.

2.2.2.3 Section 23(g) - prohibition of the deduction of non-trade expenditure

Section 23(g) of the Act provided as follows before its amendment in 1992: “No deductions shall in any case be made in respect of ... any monies claimed as a deduction from income derived from trade, which are not wholly and exclusively laid out or expended for the purposes of trade.” This wording embodied an all-or-nothing approach, as a deduction would be disallowed if any portion of expenditure was not incurred for the purposes of trade (Moosa & Omar, 1998: 18). If expenditure was incurred for a dual purpose, section 23(g) would come into effect, irrespective of the fact that the non-trade purpose might have been secondary or insignificant. Furthermore, considerable difficulty was often experienced in distinguishing between instances where expenditure was exclusively incurred for the purposes of trade but produced incidental non-trade effects and instances where expenditure was incurred with a dual purpose in view.

Because of the inevitable inequity and uncertainty created by the previous wording of section 23(g), it was amended in 1992 to read as follows: “No deductions shall in any case be made in respect of any moneys, claimed as a deduction from income derived from trade, to the extent to which such moneys were not laid out or expended for the purposes of trade.” Section 23(g) in its present form therefore provides for the apportionment of expenditure between its trade and non-trade components and only prohibits a deduction in respect of the non-trade component (Huxham & Haupt, 1997: 71).

It should be noted that section 11(a) also contains a trade requirement by stating that expenditure and losses to be deducted under that section must be incurred in the production of income derived from trade. Section 23(g) therefore elaborates on the trade requirement of section 11(a), by addressing the case where expenditure or losses are incurred for both trade and non-trade purposes.

2.2.2.4 Comparison of the requirements with regard to inclusions in gross income and deductions

When the general definition of gross income in section 1 is compared to the general deduction formula in section 11(a), the following similarities can be identified:

- Both provisions contain timing requirements. The general definition of gross income states that an amount shall be included in gross income during the year in which that amount was received by or accrued to a person. With regard to the general deduction formula, it was established in *Concentra* that expenditure and losses shall be deducted in the year of assessment in which they are actually incurred.
- Both provisions exclude amounts of a capital nature.

The following differences exist with regard to the restrictive requirements of the two provisions:

- The general definition of gross income contains certain source requirements. These requirements are not particularly relevant for the purposes of this work. The reason is that these requirements merely establish the method by which taxable amounts are captured in the South African tax net. A group tax regime will not influence this method. Instead, it will deal with taxable amounts so captured within a group context.
- The general deduction formula, as qualified by section 23(g), states that expenditure and losses will only be deductible if incurred in the production of income derived from a South African trade.

The remainder of section 2.2 will demonstrate how the differences as well as the apparent similarities between the restrictive requirements of the general definition of gross income and the general deduction formula can produce tax anomalies within a group context.

2.2.3 *Timing mismatches*

The general definition of gross income states that an amount will be included in a person's gross income in the year of assessment in which it is received by or has accrued to that person. The word "or" in the phrase "received by or accrued to" implies that two separate nets are cast out - one for all amounts received by a taxpayer, and the other for all amounts accrued to that taxpayer.

However there is a necessary implication against double taxation in instances where an amount is received by and accrues to a taxpayer in different years of assessment (CIR v Delfos, 1933). “Received” means received by the taxpayer in his personal capacity and for his own benefit (Geldenhuys v CIR, 1947). “Accrued” means that the taxpayer has become unconditionally entitled to the amount (CIR v People’s Stores (Walvis Bay) (Pty) Ltd, 1990).

Concerning the phrase “actually incurred”, which is used in the general deduction formula, it was established in Port Elizabeth Electric Tramway Co Ltd v CIR (1936) that “actually incurred” cannot mean actually paid. So long as the liability to pay the expense has been actually incurred, it may be claimed as a deduction. In Nasionale Pers Bpk v KBI (1986), it was further stated that the phrase in question implied an absolute and unconditional legal liability.

An interesting point that emerges when the phrase “received by or accrued to” is compared to the phrase “actually incurred”, is that the latter does not include the word “paid” as in “actually paid or incurred by”. This raises the question whether timing differences can arise in the case of general income/expenditure transactions. The examination of the facts of ITC 675 (1949) will provide an answer. The taxpayer in that case supplied day-old chickens to its customers and required payments to be made in advance before orders would be executed. The matter to be decided was whether deposits held by the taxpayer at year-end in respect of unexecuted orders were “received” by him. It was clear that the deposits had not accrued to the taxpayer, as he would only become unconditionally entitled to them once the chickens were delivered to customers.

The Court stated that the only instance in which the deposits would not be received by the taxpayer was where such deposits were held in trust for repayment to its customers on the contingency that their orders were not fulfilled. The Court referred to the fact that the deposits were merged into the general funds of the company and could be utilised in the company’s business as it pleased, and concluded that the deposits were not held in trust. Consequently, such deposits were received by the taxpayer within the meaning of the general definition of gross income.

Assuming that the taxpayer and its customers had corresponding years of assessment, it is unlikely that the deposits in question would be expenditure actually incurred during that particular year of assessment. Because customers could claim refunds in case of non-delivery of chickens, they did not incur an absolute and unqualified liability at year-end.

The conditional payment of a deposit between two group members, which is not held in trust by the receiver, may therefore have anomalous tax results. From a group perspective, such a payment represents a zero net cash flow. And although the inclusion of the receipt in taxable income in one year of assessment will be followed by the deduction of the corresponding expenditure in a succeeding year of assessment, the delayed deduction will produce a negative net present value of tax cash flows. The payment of a deposit between two divisions of a single company, on the other hand, will produce no such effect.

2.2.4 Taxability/deductibility mismatches due to non-compliance with the production of income and trade requirements of section 11(a) and 23(g)

2.2.4.1 Introduction

Section 11(a) requires that expenditure or losses must be incurred in the production of income derived from trade before such expenditure or losses will be deductible. Section 23(g) prohibits the deduction of monies, claimed as a deduction from income derived from trade, to the extent to which such monies were not laid out or expended for the purposes of trade. Similar requirements are not contained in the general definition of gross income. Consequently, expenditure in respect of a general income/expenditure transaction must overcome additional hurdles before a tax neutral result will be achieved from a group perspective.

Intra-group tax anomalies with regard to the production of income and trade requirements of sections 11(a) and 23(g) may arise in two instances. The first instance is where an expense or loss is not deductible by the group company that incurred it, because the production of income and trade requirement are not satisfied at all, while the corresponding receipt/accrual is included in

another group company's gross income. The second instance is where an expense or loss is not deductible by the group company that incurred it (while the corresponding receipt/accrual is included in another group company's gross income), because the production of income and trade requirements are not satisfied in relation to the group company that incurred the expenditure, although it may be satisfied in relation to the other group company or the group as a whole.

2.2.4.2 Instances where expenditure or losses do not satisfy the production of income or trade requirements of sections 11(a) and 23(g) at all

The application of the phrase "expenditure incurred in the production of income derived from trade" was explained by Watermeyer AJP in *Port Elizabeth Electric Tramway Co Ltd v CIR* (1936). He stated that, in the ordinary sense, it is not expenditure that produces income, but rather business operations and that expenditure is attendant upon these operations. To determine whether expenditure is incurred in the production of income derived from trade, it must be ascertained whether the related operation produces income. The answer will be in the affirmative if the operation is done *bona fide* for the purpose of carrying on the trade that earns income. The expenses attendant on the performance of that operation will then be deductible. The question of how closely the expenses must be linked to the business operation was answered as follows by Watermeyer: "...in my opinion, all expenses attached to the performance of a business operation *bona fide* performed for the purpose of earning income are deductible whether such expenses are necessary for its performance or attached to it by chance or are *bona fide* incurred for the more efficient performance of such operations provided they are so closely connected with it that they may be regarded as part of the cost of performing it."

Ordinary business expenditure should satisfy the production of income and trade requirements relatively easily. Such expenditure will fall under the category of expenses necessary for the performance of business operations, or the category of expenses incurred *bona fide* for the more efficient performance of such operations. However, the remaining category of business expenses, namely expenses attached to business operations by chance, may experience difficulty in satisfying the requirements in question of section 11(a) and section 23(g). An example of such expenditure is damages payable due to negligence. Perhaps the most authoritative test to be

applied to such expenditure was laid down in *COT v Rendle* (1965). In that case, it was decided that with regard to accidental expenditure, it is the risk of the mishap giving rise to the expenditure, instead of the expenditure itself, which must be closely linked with the business operations. Otherwise, the reference to accidental expenditure in *Port Elizabeth Electrical Tramways* would have been without any purpose. In addressing the issue of how close the risk must be to the business operations, Beadle CJ stated that “it should be inseparable from or a necessary incident of the carrying on of the particular business”.

An earlier case, *Joffe & Co (Pty) Ltd v CIR* (1946), specifically dealt with the deductibility of damages arising from negligence. The taxpayer in question was a construction engineer who was liable for damages as result of an accident caused by faulty construction. Watermeyer CJ disallowed the expenditure on the grounds that “there is nothing in the stated case to suggest that such negligence, and the consequent liability which the negligence entailed, were necessary concomitants of the trading operations of a construction engineer”. It can be said that the test formulated in *Joffe* with regard to damages is a specific version of the general test formulated in *Rendle* with regard to all incidental expenditure, as damages are a specific form of accidental expenditure, while negligence is a specific mishap giving rise to accidental expenditure.

The general definition of gross income contains no requirement similar to the production of income and trade requirements of sections 11(a) and 23(g). Thus, it may happen in the case of an incidental payment made by one group company to another that the amount received by the one company will be taxable, while the corresponding payment will not be deductible by the other because of failing the tests formulated in *Rendle* and *Joffe*.

2.2.4.3 Instances where expenditure or losses do not satisfy the production of income or trade requirements of sections 11(a) and 23(g) in relation to the group companies that incurred them

It may happen that a group company incurs expenditure for purposes of the group’s trade. In such an instance, the expenditure in question may not satisfy the production of income and trade requirements in relation to the particular company that incurred the expenditure. The narrow application of the production of income and trade tests to separate group companies is illustrated

in the following two cases, namely ITC 648 (1947) and Van Leer Packaging (Rhodesia) (Pvt.) Ltd. v COT (1970).

ITC 648

This particular case examined the question whether a payment made by a holding company to its subsidiary to recoup losses sustained by the latter was an allowable deduction under section 14(2)(a) of the Income Tax Act of 1941. The issue that had to be decided was if the payment was made for purposes of the holding company's trade.

The facts of the case can be described as follow. In accordance with an arrangement made between the holding company and its subsidiary, goods sold by the subsidiary to third parties were charged at cost plus 10%, while goods sold by the subsidiary to the holding company were charged at cost plus 2,5%. The holding company made a payment of £4 060 to the subsidiary, representing compensation for the accumulated losses incurred by the latter during the two years ended on 30 June 1944 and 1945 respectively. It was claimed that the accumulated losses incurred by the subsidiary during this period were entirely attributable to the low rate at which goods were sold by it to the holding company.

The Court stated that the only way in which the payment could be regarded as being incurred for purposes of the holding company's trade was if the separate personality of the subsidiary was disregarded, and that such disregard would be inappropriate. Viewing the holding company in isolation, the Court concluded that the payment was made not because of the strength of a moral claim to correct an erroneous charge, but because the interests in both companies were identical and it was a convenient way of dealing with the matter of the accumulated losses. (Concerning the last finding, the Court probably alluded to the shifting of income between group members to accelerate the utilisation of assessed losses.) It was further held that the amount was not laid out for the taxpayer's business, but that it was laid out as a contribution to assist the subsidiary in its business. Because the payment was therefore not made for purposes of the holding company's trade, it was not allowed as a deduction.

The amount received by the subsidiary was almost certainly included in the gross income of the subsidiary, as it would have satisfied all the requirements for inclusion contained in the general definition of gross income.

As an aside, the Court remarked that an initial agreement of a different kind might have resulted in the granting of a deduction. If, for instance, the holding company and its subsidiary agreed that the initial price would be cost price plus 2,5%, but that an additional amount would be paid to the subsidiary to enable it to run at a profit, then the payment, being contractually claimable in accordance with the original bargain, would have been made for purposes of the holding company's trade. This argument of the Court contains an element of artificiality. The special relationship that exists between group companies eliminates the need for the conclusion of formal agreements in advance of transactions. By requiring compliance with such formalities as a condition for deductibility of the payment, the commercial flexibility inherent in group relationships is significantly compromised.

Van Leer Packaging (Rhodesia) (Pvt.) Ltd. v Commissioner of Taxes

This case dealt with the deductibility of amounts paid by the taxpayer to its holding company in respect of experiments and research carried out by other group companies for the benefit of the group as a whole. The cost of the experiments and research was charged out by the research companies to the holding company. The latter then apportioned the cost against other members of the group. Previously, individual companies within the group had conducted their own research, but this was found to be uneconomical and consequently the above arrangement was devised.

Although any member of the group confronted with a specific problem could refer it to one of the research depots, no group company had the right to insist that work had to be done in any particular field or on any particular problem. During the year of assessment for which a deduction was claimed by Van Leer in respect of its contribution to the group's cost of research and development, no research work was carried out at Van Leer's request.

The court firstly examined the issue whether the contribution was deductible under a section which specifically dealt with research and development costs. For reasons of interpretation not relevant to this study, it was decided that the contribution did not qualify for deduction under that section. The court then directed its attention to the possibility of a deduction under section 14(2)(a) of the Rhodesian Income Tax Act (which was very similar to section 11(a) of the present South African Act). In its judgement on the matter, the Court stated that the contribution did not represent the cost of research carried out by the taxpayer in its personal capacity, or the cost of research carried out by an independent contractor at the specific request of the taxpayer. It was further stated that the onus rested on Van Leer to establish on a balance of probabilities that the contribution was expended for the purposes of its trade and in the production of its income. The Court concluded that the evidence led by Van Leer did not assist in discharging the onus on any of these points. On the contrary, it indicated that much of the research was not concerned with the income-earning operations or even the income-earning structure of the taxpayer, but rather with the income-earning structure of the group when considered as a whole and independently of its constituent members. Consequently, the expenditure was held to be non-deductible by Van Leer under the general deduction formula.

The trade test contained in section 11(a) and expanded by section 23(g) is essentially an economic test. As such, it should be applied to economic entities, instead of legal sub-entities. As can be seen from this case, and other cases which will follow, the treatment of individual group companies as taxable entities leads to the application of the trade test to legal sub-units within the economic unit. This may produce anomalous tax results, as will be illustrated by an analysis of the operational cash flows and their tax effects in the case under discussion.

The operational cash flows resulting from the arrangement in the Van Leer case are presented in Table 2.1, assuming that the amount of Van Leer's contribution was R100 and that the associated cost incurred by the research company was also R100.

Table 2.1**Van Leer Packaging (Rhodesia) (Pvt.) Ltd. v CoT: hypothetical operational cash flows of the arrangement with regard to group companies**

	Van Leer	Holding company	Research company	Group
Costs incurred by research company	-	-	(100)	(100)
Amount charged to holding company	-	(100)	100	-
Contribution by Van Leer	(100)	100	-	-
Net cash flows	(100)	-	-	(100)

As can be seen from the above table, Van Leer effectively financed the research cost. The holding company merely served as a channel through which the contribution was directed from the ultimate bearer of the cost, namely Van Leer, to the initial incurrer of that cost, namely the research company.

With regard to the tax effects of the arrangement, the Court held that Van Leer was not entitled to a deduction of its contribution. The Court did not consider the positions of the holding company and the research company, and it is therefore necessary to venture an opinion as to the tax implications of the arrangement on these entities. The research company probably had to include the amount received from the holding company in its gross income, as it would have constituted a normal trade receipt. If the costs incurred by the research company were of a revenue nature, they would have been deductible under the general deduction formula, as they represented a normal cost of its business of research.

The holding company's position poses an interesting problem. If it is assumed that the holding company did not act as an agent of the research company by merely collecting amounts for the latter, the contribution received by it from Van Leer would be included in its gross income. However, the amount paid over to the research company would not be deductible under the general deduction formula for the same reason advanced in the Van Leer case, namely that the research was conducted for the benefit of the group and not for the specific benefit of the holding company. If, on the other hand, it is assumed that the holding company acted as the agent of the research company, the transaction would have no tax implications for the holding company, as the contribution would not have accrued to it or have been received by it within the meaning of the general definition of gross income. For the sake of clarity, the tax results of the arrangement under the two alternatives will be presented in the Table 2.2 and Table 2.3.

Table 2.2

Van Leer Packaging (Rhodesia) (Pvt) Ltd v CoT: tax effects of the arrangement, assuming that the holding company did not act as an agent of the research company

	Van Leer	Holding company	Research company	Group
Gross income	-	100	100	200
Deductions	-	-	(100)	(100)
Taxable income	-	100	-	100
Incremental tax at 30%	-	30	-	30

Table 2.3

Van Leer Packaging (Rhodesia) (Pvt) Ltd v CoT: tax effects of the arrangement, assuming that the holding company did act as an agent of the research company

	Van Leer	Holding company	Research company	Group
Gross income	-	-	100	100
Deductions	-	-	(100)	(100)
Taxable income	-	-	-	-
Incremental tax at 30%	-	-	-	-

If the operational cash flows in respect of the arrangement are compared with the associated tax cash flows, it will be realised that the tax effects from a group perspective are extremely anomalous. Under both alternatives, the effective operational cash outflow of the group is R100, representing the actual cost of research incurred by the research company. Under the first alternative, the incurrence of research costs by the group leads to the *payment* of additional income tax of R30. Under the second alternative, the tax effect is not as harsh, but it is by no means satisfactory. Although the group is not taxed as result of the costs incurred by it, it nevertheless receives no tax relief in respect of such costs.

If the group in question had been a divisionalised company, a separate research and development department funded by the various operating departments would have conducted all research activities. The research and development department would still not have carried out activities at the specific request of each operating department. However, the fact that the costs were incurred for the benefit of the company as a whole instead of specific operating divisions would not have prohibited a deduction under the general deduction formula, because the company would have been treated as the taxable entity.

It is clear that the differing tax treatment of groups and divisionalised companies in the above example is inequitable. Furthermore, the tax results of the arrangement in the Van Leer case might have encouraged the group to conduct its research on a decentralised basis again, thereby compromising neutrality and causing a less efficient use of resources.

2.2.5 Taxability/deductibility mismatches due to capital/revenue differences

2.2.5.1 Capital/revenue considerations with regard to gross income

The general definition of gross income excludes amounts of a capital nature. The distinction between capital and revenue can be explained in economic terms by stating that capital is the machine or structure that generates income or revenue. In *CIR v Visser* the example of a tree and its fruits was used to illustrate the difference between the two concepts. The tree is employed as a capital asset to produce fruit: an amount received by disposing of the fruit will be of a revenue nature, while an amount received by realizing the tree will be of a capital nature (Huxham & Haupt, 1997: 25).

No particular difficulty should be experienced in distinguishing between capital and revenue on a conceptual level. However, considerable difficulty may be experienced in determining on the facts of a particular case whether an amount is in respect of a tree or its fruits. For example, income may be produced by way of rents from property, in which case the property is the income-producing machine. But income may also be derived from the business of property dealing, in which case it is the business of property dealing which is the income-producing machine, while amounts received from the disposal of properties will be of a revenue nature (Meyerowitz, 1997: 8-3). From this example, it is clear that the nature of the transaction is far more important than the nature of the asset in question.

The nature of a transaction is determined by the intention of the taxpayer (Huxham and Haupt, 1997: 25). A taxpayer may dispose of an asset by an operation of business in carrying out a scheme for profit making, in which case the proceeds on disposal will be of a revenue nature.

Alternatively, a taxpayer may realise an asset as a mere change of investment, in which case the proceeds on disposal will be of a capital nature (*Overseas Trust Corporation Limited v CIR*, 1926). Over the years the courts have evolved the application of the test of intention into a bewildering variety of permutations. Not only must the intention of the taxpayer at the date of acquisition of an asset be considered, but also the possibility of a change in intention before disposal of the asset (*CIR v Stott*, 1928; *Natal Estates Ltd v CIR*, 1975). Furthermore a taxpayer may have more than one intention with regard to a particular asset, in which case one intention may be dominant (*COT v Levy*, 1952). In other cases, however, neither intention may be dominant, with result that the taxpayer can be described as having a dual intention (Meyerowitz, 1997: 8-19). To further add to the uncertainty, the following was said by Steyn CJ in *CIR v African Oxygen Limited*: “In so far as cases in our courts decide which factors are to be taken into account in dealing with such question ... they are, of course, of assistance, but each case must be decided on its own facts and circumstances.”

2.2.5.2 Capital/revenue considerations with regard to the general deduction formula

The general deduction formula echoes the general definition of gross income by excluding expenditure and losses of a capital nature from deductibility. Two prominent cases that dealt with the capital/revenue issue in respect of expenditure and losses are *CIR v George Forest Timber Co* (1924) and *New State Areas Ltd v CIR* (1946).

In *George Forest Timber* the difference between capital and revenue expenditure was described as follows: “Money spent in creating or acquiring an income-producing concern must be of a capital nature. It was invested to yield a future profit and while the outlay did not recur, the income did. There was a great difference between money spent in creating or acquiring a source of profit, and money spent in working it. The one was capital expenditure, the other was not.”

In *New State Areas*, Watermeyer CJ stated that expenditure attendant on the performance of operations that produce income is of a revenue nature, while expenditure incurred in the acquisition, expansion or improvement of the means of production (such as property and plant) is of a capital nature. With regard to capital expenditure, a further distinction was made between

floating and fixed capital. When capital employed in a business is frequently changing its form from money to goods and *vice versa* (for example, the purchase and sale of trading stock by a merchant) and this is done for the purpose of making a profit, then the capital so employed is floating capital, which will be deductible. Watermeyer remarked that the problem which arises when distinguishing between capital and revenue expenditure is usually whether the expenditure in question should properly be regarded as the cost of performing the income-earning operations or as part of the cost of the income-earning plant or machinery. After considering various tests formulated in other cases, he concluded that “the true nature of each transaction must be enquired into in order to determine whether the expenditure attached to it is capital or revenue expenditure. Its true nature is a matter of fact...”

2.2.5.3 Comparison of the considerations

The tests employed to determine the capital or revenue nature of receipts and accruals, on the one hand, and of expenditure, on the other, are very similar conceptually. For example, in the case of CIR Visser (which dealt with a receipt) capital assets were referred to as income-producing machines while in New State Areas, which dealt with expenditure, an almost identical phrase was used to explain the concept of capital expenditure, namely “income-earning plant or machinery”. The conceptual similarities between the tests employed in the case of receipts/accruals and the tests employed in the case of expenditure and losses are to be expected, as the general deduction formula concerns itself with the outgoing resulting from the acquisition of an asset, while the general definition of gross income concerns itself with the incoming resulting from the disposal of that asset.

Other similarities can also be found. With regard to receipts and accruals the test of intention, although varied in its application, is a golden thread that runs through the vast majority of cases that decided the nature of specific receipts and accruals. With regard to expenditure, the previously quoted dictum of Watermeyer CJ in the authoritative New State Areas identified the purpose of expenditure as an important factor in determining its true nature.

With regard to the significance that can be attached to specific tests formulated in other cases, the sentiments of Steyn CJ in *African Oxygen*, which dealt with a receipt, were echoed by Viscount Radcliffe in *COT v N'changa Consolidated Copper Mines Ltd* (1964), which dealt with expenditure, when he said the following: "Nevertheless, it must be remembered that all these phrases, as, for instance, 'enduring benefit' or 'capital structure' are essentially descriptive rather than definitive, and, as each new case arises for jurisdiction and it is sought to reason by analogy from its facts to those of one previously decided, a court's primary duty is to enquire how far a description that was both relevant and significant to one set of circumstances is either relevant or significant in those which are presently before it." It is therefore clear that the courts will focus on the facts of each particular case in deciding the capital or revenue nature of expenditure. The guidelines established in other cases will be considered but they will by no means be decisive.

Although the broad guidelines for distinguishing between capital and revenue receipts/accruals as well as capital and revenue expenditure are very similar, the application of such guidelines to the opposing legs of a transaction is not coordinated. The case of *COT v N'changa Consolidated Copper Mines Ltd* (1964) is an example of the asynchronous application of the guidelines within a group context.

2.2.5.4 *COT v N'changa Consolidated Copper Mines Ltd*

The facts of the case are as follows. N'changa was a mining company that made a payment to a fellow subsidiary, Bancroft Mines Ltd, as consideration for taking over a portion of the latter's intended mining production for a particular year. The Commissioner of Taxes contended that the payment was of a capital nature and therefore not deductible. However, the Judicial Committee of the Privy Council found that the payment was similar to a monetary levy paid on the production for a year, and that it should be viewed as a cost incidental to the production and sale of N'changa's output. As the payment therefore represented a cost of its income-earning operations, rather than a cost of establishing or adding to or improving its income-earning plant or machinery, it was held to be of a revenue nature.

The Judicial Committee did not consider whether the amount received by Bancroft was of a capital or revenue nature. An answer to this question may be found, however, by examining the case of *Tauber and Corssen (Pty) Ltd v SIR* (1975). The taxpayer in that case received an amount on the termination of an agency agreement as compensation for refraining from selling similar products of competitors of the principal, BASF, for a period of two years. The amount was calculated as a percentage of the profits earned from the particular agency agreement in the twelve months preceding its termination. The Secretary for Inland Revenue contended that the amount was intended to fill a hole in the income of the taxpayer, rather than a hole in his income-producing machine, and that it consequently was of a revenue nature. The Court, however, found that the payment to Tauber and Corssen was made as compensation for neutralising a part of its income-producing structure geared towards the selling of products of a particular type, and was therefore of a capital nature. The fact that the restraint of trade was effective for two years only, and the fact that the compensation was calculated with reference to past profits, was held by the Court to be irrelevant.

In the *N'changa Copper* case, the Judicial Committee held that the payment made to Bancroft by N'changa was for the right to have Bancroft out of production for a period of twelve months. Applying the principle established in *Tauber and Corssen* to that finding, it is difficult to argue that the receipt was not of a capital nature in Bancroft's hands. In fact, the Commissioner contended in the Federal Supreme Court (*N'Changa Consolidated Copper Mines Ltd v CIR*, 1961) that the payment made by N'changa must be of a capital nature because the amount received by Bancroft was of a capital nature (*N'Changa Consolidated Copper Mines Ltd v COT*, 1962). Clayden CJ responded as follows to that contention: "I do not propose to discuss Bancroft's position. Assuming that it was a capital receipt, that fact has no real bearing on Nchanga's liability for tax."

The tax result in the *N'changa* case is extremely anomalous. The group of which N'changa and Bancroft were members received a deduction in respect of the payment made by N'changa, without having to include Bancroft's corresponding receipt in gross income. It experienced a zero net cash flow with regard to the intra-group payment, but received tax relief nevertheless.

The anomalies with regard to the capital or revenue nature of corresponding amounts will not always be in favour of taxpayers. It may happen that the expenditure component of an intra-group transaction is viewed as capital, while the receipt/accrual component thereof is viewed as income.

By not coordinating decisions about the nature of income and corresponding expenditure that arise from intra-group transactions, a fertile ground for tax anomalies is created. Commercial reality dictates that transactions are often infinitely complex in both design and execution, resulting in a multitude of attendant facts and circumstances. When the parties to a transaction are viewed in isolation, it is possible that different facts and circumstances will be considered in each case, or that the same facts and circumstances will be interpreted differently, resulting in conflicting decisions about the nature of the amount in question.

2.3 COSTS INCURRED IN RESPECT OF THE PROVISION OF INTRA-GROUP SERVICES

2.3.1 Introduction

Section 2.3 will consider the tax implications of the costs incurred by a group company in providing a service to another group company, whereas section 2.2 considered the tax implications of the relevant intra-group transaction. The deductibility of such costs revolves around an application of the production of income and trade requirements of sections 11(a) and 23(g). An intra-group service may initially be provided at a loss for sound commercial reasons other than the transfer of income to the receiver of the service to accelerate the utilisation of an assessed loss. In such an instance the provider of the service may experience difficulty in satisfying the above-mentioned requirements in respect of the costs incurred by it, as an examination of relevant court cases will reveal.

2.3.2 Relevant court cases

2.3.2.1 ITC 1037 (1963)

ITC 1037 dealt with the deductibility by a taxpayer of expenditure in excess of rental income derived from a property. The taxpayer was a wholly owned subsidiary of another company. The latter company decided to acquire a business occupying a portion of a certain building. In order to obtain security of tenure for that business, the property was purchased by the taxpayer. During the first year of assessment in which the property was acquired, expenditure in relation to the property exceeded rental income by R1 325. The Commissioner of Inland Revenue disallowed such excess expenditure on the grounds that it was not expended wholly and exclusively for purposes of the taxpayer's trade.

The Court stated that one of the difficulties that it experienced with the case was the fact that the taxpayer was a wholly owned subsidiary. It therefore did not appear as if the directors of the taxpayer devoted independent consideration to the question whether the purchase of the property would be to its advantage, as opposed to the advantage of the parent company. The Court held that the only advantage that the taxpayer could possibly derive from the purchase, if considered in isolation, was to obtain income from the property by way of rents. Consequently, if it could be demonstrated that the directors of the taxpayer had a reasonable belief that the property would be a sound investment, in the sense that the taxpayer would be able to make a profit out of the property within a reasonable time, then the excess expenditure would be allowed as a deduction.

After analysing the rental income and expenditure of the taxpayer during the year of assessment in which the property was acquired, the Court found that there was little or no prospect of the company earning a profit from the property within a reasonable period of time. This analysis in itself was questionable. No attention was devoted to future projections of profitability, although the renting of property is a long-term venture in which initial losses are recouped by later profits. The Court concluded that the purchase was entered into with the predominant object of ensuring that the occupation of certain premises would be secure for the taxpayer's holding company. As

the expenditure was incurred primarily to serve the purposes of the taxpayer's holding company, it was not laid out wholly and exclusively for the taxpayer's own trade. Consequently, the Court confirmed the Commissioner's assessment.

It is interesting to note that the result of this judgement is more in harmony with section 23(g) after its amendment than before. On a strict interpretation of section 23(g) in its unamended form, the whole amount of an expense must be disallowed as a deduction if the sole purpose thereof is not related to the taxpayer's trade. However, the Court seemed to apportion the expenditure in question between its trade and non-trade components, holding that the expenditure in excess of the rental income was not incurred for the purposes of trade. Only after its amendment in 1992 did section 23(g) make provision for such apportionment. Although the Court's application of section 23(g) as it then stood might not have been entirely correct, a useful guideline was established for the application of section 23(g) in its present form.

Once more the application of 23(g) to a legal sub-unit, instead of the economic unit, produced an anomalous result from a group perspective. Although the inclusion in the taxpayer's gross income of the rental received from the holding company would have been neutralised by a corresponding deduction to the holding company, the group was not allowed a deduction of the full amount of the taxpayer's expenditure, which represented the group's effective cost in respect of its rental activities.

Had the property been owned by the holding company, the expenditure incurred in excess of rental income earned from outside parties would have been deductible against its other operating income. The reason is that there would have been a dual trade purpose in holding the property, namely to derive rental income from the portion of the property which was not required for the activities of the acquired business and to obtain security of tenure for that business.

2.3.2.2 CIR v Sunnyside Centre (Pty) Ltd (1996)

Sunnyside Centre was a wholly owned subsidiary of Sam Gross Holdings (Pty) Ltd (SGH). It owned a building consisting of shops and flats, which were let out. Another wholly owned subsidiary of SGH, Agros (Pty) Ltd, needed funding to acquire a property. As Sunnyside could obtain finance at a lower rate than Agros, it was decided that Sunnyside would borrow the required funds. The money so borrowed by Sunnyside was lent to SGH, which in turn lent it to Agros. The usual informality in respect of intra-group transaction prevailed; nothing was reduced to writing and no specific agreement was reached between Sunnyside and SGH as to the rate of interest and the terms of repayment. However, it was intended that SGH would eventually pay Sunnyside all interest that the latter incurred, together with the capital sum. Sunnyside was therefore not to suffer a loss as result of the arrangement. A feasibility study indicated that it would take some years before rentals on the property to be acquired by Agros could be raised to a level that would match the interest burden of Sunnyside. Thus, the interest initially incurred by Sunnyside would exceed the interest received from SGH, although the situation would be reversed in later years.

The Court had to decide whether interest paid by Sunnyside in excess of interest received by it, were laid out for the purpose of its trade, and if so, whether the excess portion was wholly and exclusively laid out for such purpose. The Court stated that section 23(g) applied to the case in its unamended form, and as such it embodied an all-or-nothing approach. It is submitted, however, that the Court applied section 23(g) in its amended form by dividing the total amount of interest expenditure into two components - one component equal to the amount of interest received by Sunnyside from Agros and the other component representing the excess amount - and focusing on the purpose of the second component. Had the court followed a strict interpretation of section 23(g) in its unamended form, it would have focused on the interest expense in its entirety in determining the purpose for which it was laid out. The principles established in this case may therefore serve as useful guidelines for the application of section 23(g) in its present form.

Turning firstly to the question whether the excess interest was laid out wholly and exclusively for the purpose of Sunnyside's trade, the Court referred to the fact that no formal contract was

concluded specifying the terms of the loan. Instead, such terms were subject to future *ad hoc* determination. It was further found that Sunnyside did not expect to profit from the reinvestment of the borrowed funds. Based on the above-mentioned findings, the Court concluded that the real object of the borrowing and lending of the funds was to enable Agros to pay for its acquisition. As there was a purpose other than deriving income from its own trade, the excess interest was held to be non-deductible.

The main implication of this judgement is that a formal, written agreement should be compiled in cases where an intra-group transaction is concluded which will result in initial losses to one of the group companies. By complying with formalities that are usually required in transactions concluded between parties at arm's length, group companies may demonstrate independent trade intentions. However, by following such an approach, artificiality is introduced into intra-group transactions and economic flexibility is sacrificed.

Having found that the excess expenditure was not wholly and exclusively laid out for the purpose of Sunnyside's trade, the Court proceeded to consider whether the excess amount was laid out for trade purposes at all although the Court stated that an inquiry on that matter was not necessary. On the facts stated, the Court concluded that Sunnyside did not intend to profit from the transaction, but that at most it hoped to recover its costs eventually. With regard to the question whether profit is an essential requirement of the carrying on of a trade, the following extract from the judgement in *De Beers Holdings (Pty) Ltd.* was quoted: "It is true ... that the absence of profit does not necessarily exclude a transaction from being part of a taxpayer's trade; and corresponding moneys laid out in a non-profitable transaction may nevertheless be wholly or exclusively expended for the purposes of trade within the terms of section 23(g). Such moneys may well be disbursed on the grounds of commercial expediency or in order to indirectly promote the carrying on of the taxpayer's trade ... Where, however, a trader normally carries on a business by buying goods and selling them at a profit, then as a general rule a transaction entered into with the purpose of not making a profit, or even suffering a loss, must, in order to satisfy section 23(g), be shown to have been so connected with the pursuit of the taxpayer's trade, e.g. on the grounds of commercial expediency or indirect facilitation of the trade, as to justify the conclusion that, despite the lack of a profit motive, the moneys paid out under the transaction

were wholly and exclusively expended for the purposes of trade ... Generally, unless the facts speak for themselves, this will call for an explanation from the taxpayer.”

Sunnyside, being unable to prove that it entered into the scheme to earn a profit, sought to bring itself under the heads of commercial expediency or indirect facilitation of trade, by arguing that it was expedient to maintain an arrangement whereby SGH provided administrative services to all three companies and acted as the ‘banker’ of the group. However, the Court found that there was an atmosphere of unreality in the submission that it was expedient to keep the directors of the holding company ‘sweet’, in order to persuade them to continue running the group’s affairs to Sunnyside’s benefit. No evidence was presented, for instance, that Sunnyside lent assistance in order to ward off higher service charges, or to stave off a failure of Agros such as might ultimately have affected the solvency of the group and even Sunnyside itself. The Court conceded that facts of that kind might have been enough to satisfy the test of commercial expediency or indirect facilitation of Sunnyside’s trade, but emphasised that such facts had not been established.

Where ITC 1037 implied that the earning of profit is necessary before costs incurred in respect of the provision of intra-group services will be deductible, the Sunnyside case indicated that costs incurred in respect of such transactions may satisfy the trade requirement of sections 11(a) and 23(g) on grounds other than the earning of profit. Nevertheless, from the Court’s application of the De Beers principle to the facts of the Sunnyside case, it is clear that groups will experience considerable difficulty in demonstrating such grounds where intra-group services are provided *bona fide* at a loss.

2.4 COSTS INCURRED BY ONE GROUP COMPANY FOR THE BENEFIT OF ANOTHER

In certain instances one group member may incur costs for the benefit of another group member. Where no or inconsequential minority shareholdings exist within a group structure, it is not important which legal sub-unit within the group incurs the particular costs. However, the production of income and trade requirements of sections 11(a) and 23(g) will prevent a deduction

of such costs when they do not relate to the trade of the specific group company that incurred them. This is illustrated in ITC 630 (1946).

The case dealt with the deductibility of expenditure incurred by a taxpayer in respect of employees engaged in the business of one of its subsidiaries. The taxpayer made certain payments, by way of salaries and travelling expenses, to two of its employees who had been engaged in reorganising the business of a subsidiary company in which it had acquired a shareholding. During the year of assessment, goods had been supplied to the subsidiary by the taxpayer at prices representing cost plus 5%.

The Commissioner refused to allow a deduction in respect of the payments, contending that they were not incurred in the production of the taxpayer's income and for the purposes of his trade.

In delivering judgement the Court referred to the distinction between subsidiaries and divisions, and the apparent confusion in the mind of the taxpayer between the two concepts. The following was said in this regard: "It would seem that the distinction between branches and subsidiary companies, being independent *persona*, was not present in the mind of the appellant's officials... For, in cross-examination, the public officer of the company ... admitted that the appellant regarded this particular subsidiary company as a branch. Although expenditure in respect of a branch, taking the form of salaries and expenses of officials of the appellant's head office staff who do work for the advancement of such branch, would no doubt be expenditure incurred in the production of the appellant's income, the same expenditure designed to improve the position of a subsidiary incorporated company would *prima facie* not be on the same footing. For the connection between such expenditure on a branch and the income of the appellant would be a direct one inasmuch as the income of the branch is part of the income of the appellant. But the same cannot be said of the expenditure on the subsidiary company which is a separate and independent *persona* and a taxpayer having its own income distinct for all purposes ... from the appellant's."

The circumstances of this case provide concrete proof of the misunderstanding that often exists in the practically orientated business world about the separate *persona* of holding companies and

their subsidiaries. Significantly, this misunderstanding is not restricted to business people involved in small and relatively simple enterprises, but often extends to business people who employ complex legal structures to contain their enterprises, as the facts of the case clearly illustrate. The officials of the holding company regarded the subsidiary as a branch for all practical purposes, and therefore did not pay particular attention to which entity should bear the costs in question. The transaction was structured with the economic substance of the group as primary consideration. As the group represented a single economic unit in reality, it did not matter to them which legal sub-unit thereof incurred the costs. However, the deduction of the costs was disallowed in view of the legal form of the group.

It is questionable whether a system of taxation for groups will operate to the satisfaction of the fiscus as well as taxpayers if it so clearly conflicts with the pragmatic practices that are often followed in the business world. No doubt, tax morality will be damaged when taxpayers receive surprises as unpleasant as the one above.

The Court further held that amounts that might be received by way of dividends from the subsidiary would not constitute income, as dividends are exempt from normal taxation. And even if dividends were not exempt from normal taxation, the Court found that the “production of income” test would still not be satisfied, because the primary purpose of the expenditure was to provide income for the subsidiary, rather than dividends for the holding company. The connection between the expenditure and any dividends would therefore not be sufficiently close. In the same light, the Court found that revenue received from goods sold to the subsidiary was merely a collateral advantage to the taxpayer and could not be viewed as the primary purpose of the expenditure.

Consequently, the appeal of the taxpayer was set aside and the Commissioner’s assessment was confirmed on the grounds that the taxpayer and its subsidiary were separate legal personae, and that the expenditure incurred by the taxpayer was in the production of the subsidiary’s income rather than its own.

2.5 INTEREST ON LOANS EMPLOYED TO FINANCE THE PURCHASE OF SHARES IN OTHER GROUP COMPANIES

2.5.1 Introduction

Section 11(a) of the Act requires expenditure to be in the production of income before it will be allowed as a deduction. Section 23(f) reinforces this positive requirement by prohibiting the deduction of “any expenses incurred in respect of any amounts received or accrued which do not constitute income as defined in section one”. ‘Income’ is defined in section one as “the amount remaining of the gross income of any person for any year or period of assessment after deducting therefrom the amounts that are exempt from normal tax under Part I of Chapter II”.

When a person purchases shares in a company and finances the purchase by way of a loan, a problem arises as to the deductibility of the interest incurred. The reason is that the dividends that flow from the shares are exempted from normal tax by section 10(1)(k) of the Act. The expenditure on interest will therefore not be in the production of income as defined.

Another tax anomaly becomes apparent when the position of a company purchasing a business by way of a branch is compared to the position of a company acquiring a business by purchasing all of the shares in another company.

In the first instance, all the requirements of section 11(a) will normally be satisfied. The business of the acquired branch will produce non-exempted revenue and interest incurred on the loan will therefore be in the production of the company’s income. Furthermore, the interest will not be of a capital nature, as it represents the cost of financing the acquisition of an asset rather than the cost of acquiring the asset (Huxham and Haupt, 1997: 81). This sentiment is echoed in ITC 1124 (1968), where it was stated that interest is the recurrent or periodical charge or ‘rental’ payable for the continued use by a person of money lent to him, and that it is therefore revenue in nature, although the money may be utilised for the acquisition of a fixed capital asset.

In the second instance, the company will not be entitled to deduct the interest. Although the interest will still be of a revenue nature it will not be incurred in the production of the company's income, as the investment in the subsidiary will yield exempt dividends to that company.

The differing treatment of interest on loans when branches or closely held subsidiaries are acquired seems inequitable. A closely held subsidiary is acquired, not as a passive investment, but as an extension of the holding company's business, which will be managed by and operationally integrated into the holding company. The legal interface between the two companies is often irrelevant from a commercial point of view. Furthermore, dividends are merely the formal mechanism to transfer business profits between separate legal entities within the same economic unit. Conceptually, therefore, it does not make sense to disallow the deduction of interest in such circumstances.

2.5.2 Relevant court cases

2.5.2.1 Introduction

Although the fruits of shares are exempt dividends, taxpayers have nevertheless sought to deduct interest on loans employed to purchase shares in subsidiaries on the grounds that there was a link between the interest and the income derived from their own trades. In the majority of cases, however, taxpayers were unsuccessful in obtaining deductions of the interest in question, as the following examination of court cases will reveal.

2.5.2.2 ITC 301 (1934)

The taxpayer in ITC 301 was a company carrying on a general trading business. With the view to expanding its operations, it acquired all the shares in another company that carried on a similar business and funded the acquisition with a loan. The newly acquired subsidiary was viewed as a branch of the holding company by the directors of the latter, and it was argued by the taxpayer that the reason for purchasing the shares instead of the underlying assets was to provide

convenient bulk security to the grantor of the loan by pledging the shares to him. The Commissioner's response was that the subsidiary was a separate legal *persona*, and that one company could not run another as a branch business.

The Court did not express an opinion on the branch/subsidiary debate and disallowed the deduction of the interest on other grounds. One of these grounds was that the purchased shares were a capital asset and that the interest was therefore of a capital nature. This finding is questionable, particularly in the light of what has been said in section 2.5.1 concerning the capital/revenue nature of interest.

However, an alternative ground on which the Court based its judgement contains more merit. The taxpayer contended that one of the main areas of activity from which it derived income was the transporting of goods to the various branch stores which it owned, including the stores belonging to the acquired company, and that the interest expenditure was therefore incurred in the production of its income. The Court responded by stating that the interest was expended on acquiring the shares in the subsidiary, and that it did not have any direct connection with the earning of its own trading income. Thus, it held that the interest was not deductible.

2.5.2.3 CIR v Drakensberg Gardens Hotel (Pty) Ltd (1960)

In contrast to the taxpayer in ITC 301, Drakensberg Gardens Hotel (Pty) Ltd was allowed a deduction in respect of interest incurred on the outstanding balance of the purchase price of shares in a subsidiary. The facts of the case were as follows. Drakensberg was a company held by a partnership. It leased a hotel and shop from an unrelated company, namely J. & M. Stiebel (Pty) Ltd. The hotel was sub-leased by Drakensberg to the partnership, while the shop was operated by itself. The hotel business of the partnership showed very good potential, but certain improvements to the buildings were required. However, Stiebel was not prepared to finance these improvements or to permit Drakensberg Gardens Hotel to do so. Consequently, Drakensberg decided to purchase the shares in Stiebel. Its stated objective with the purchase of the shares was "to obtain absolute control of the hotel and store premises, thereby ensuring for itself security of tenure and the right to make improvements as it desired and to sub-let at such increased rental as

it might determine without having to obtain the consent of third parties or itself having to pay an increased rental, as well as to secure for itself all rights to the hotel and store licenses". The transaction took the form it did, that is the purchase of the shares in Stiebel instead of the purchase of the property owned by it, to avoid the payment of transfer duty. The partnership ran the two companies in such a way that each company would show only a marginal profit. As a result, the increased expenditure of Drakensberg in the form of interest on the outstanding balance was compensated for by increased rental income received from the partnership.

Again, the issue to be decided was whether the interest was incurred in the production of Drakensberg's income. The majority of the Court, in finding that this was indeed the case, stated that the interest was not sought to be deducted against exempt dividends flowing from the shares in Stiebel, but against the increased rental received by Drakensberg from the partnership. Referring to the stated objective of Drakensberg with the purchase of the shares, the majority held that the connection between the interest expenditure and trade income of Drakensberg in the form of rentals was sufficiently close to substantiate the view that it was incurred in the production of Drakensberg's income. The fact that the acquisition was to be effected through the purchase of shares in Stiebel did not remove the interest payments too far from such income.

When comparing the judgement in this case with the judgement in ITC 301, it appears that a close link must be established between the interest expenditure incurred as result of the purchase of shares in a subsidiary and the income-earning operations of the holding company. Furthermore, link must be commercially realistic to suffice.

The establishment of a sufficiently close link may be difficult, as the courts tend *prima facie* to associate the interest with the purchased shares and the concomitant dividend stream. Exactly how difficult it can be to establish such a link is illustrated in the following two cases, where both of the taxpayers' endeavours to obtain deductions were unsuccessful.

2.5.2.4 ITC 1124 (1968)

The taxpayer in ITC 1124 was a member of a group of companies that carried on business as growers of timber plantations, saw-millers and manufacturers of wooden articles. The taxpayer's activities were confined to plantation growing, and all the timber from its plantations was sold to a saw-milling company that was a fellow member of the group. The saw-milling company did not work to full capacity due to a lack of sufficient timber. Consequently, the taxpayer purchased all the shares in two other plantation companies, whereafter these companies at all times sold their timber directly to the saw-milling company without any intervention of the taxpayer. The purchase of the shares was financed by way of a loan on which interest was paid.

The Court, in considering the deductibility of the interest, stated that if such interest was linked with the actual or prospective receipt by the taxpayer of dividends, the interest could not be allowed as a deduction. It conceded, however, that a deduction would be allowed under section 11(a) if the interest was so closely connected with the taxpayer's own income-earning operations that it would be proper, natural or reasonable to regard it as part of the costs of performing such operations. The Court proceeded to find that the income-earning operations of the taxpayer were the growing and felling of timber, the purchasing of timber from other growers and the selling of all such timber to the saw-milling company. It further stated that the purpose of the taxpayer getting control of the two other companies was not to enable it to procure and sell the latter's timber, but to cause them to sell their timber directly to the saw-milling company. No link between the interest and the operations of the taxpayer could therefore be found.

The taxpayer did present a possible link between the interest expenditure and its own trading income, by contending that competition between growers often resulted in uneconomic prices for timber. It was in the interest of the taxpayer to procure as much timber as possible for the capital-intensive saw-milling company so that it could run near full production capacity. In such a way the financial health of the saw-milling company would be ensured, enabling it to offer economic prices for the timber supplied by the taxpayer. The Court's response to this contention was that even if such a connection existed, the taxpayer did not prove that the connection was sufficiently close. According to the Court, examples of required evidence would include increases in the

volumes or prices of timber supplied by the taxpayer, or the maintenance of volumes or prices that would be unsustainable had the other two companies not supplied the saw-milling company. As the taxpayer did not establish a sufficiently close link between the interest and its own trading income, the Court disallowed a deduction in respect of the interest.

If the taxpayer in this case purchased the timber from the two acquired companies, and those companies delivered it to the saw-milling company in the capacity of agents of the taxpayer, the interest might have been deductible. However, such an arrangement could be vulnerable to an application of section 103(1) (refer to section 2.12.1), as the intervention by the taxpayer between the two timber growers and the saw miller could be considered artificial. A more effective method to prevent an application of section 103(1), might have been if the two companies physically delivered the timber to the appellant and the taxpayer in turn delivered the timber to the saw-milling company. Thus, by introducing a physical dimension to the arrangement, it would have assumed a more commercially genuine appearance than the first alternative. However, such an arrangement would probably have resulted in a less efficient distribution of timber within the group.

2.5.2.5 ITC 1356 (1981)

The taxpayer in this case was an investment holding company with interests in various subsidiaries. A loan was taken up to acquire a subsidiary, and the taxpayer claimed a deduction of the loan interest under section 11(a) on the grounds that the acquisition was made with the sole purpose of obtaining income from the subsidiary by way of management fees. In this regard, reliance was placed on the decision in CIR v Drakensberg Gardens Hotel. The taxpayer reasoned that as the taxpayer in that case obtained a deduction of interest from its rental income, it should obtain a deduction of interest from management fees earned.

The Court held that, even if it was assumed that the taxpayer's only purpose in acquiring the subsidiary was to earn management fees, the connection between the acquisition of the shares and the production of management fees was not sufficiently close. The Court stated that the purchase of the shares was not a *sine quo non* for the taxpayer to earn income by providing

management services, whereas in the Drakensberg Garden Hotel case it was necessary to acquire the subsidiary to protect and enlarge the taxpayer's source of income. It was further held that, while it could be said that the borrowing of money by the taxpayer and the acquisition of shares in the subsidiary assisted in creating the opportunity to render management services, this was not enough to merit the view that the interest expenditure was incurred for the purpose of a supposed trade in which management services were provided.

The Court's decision in ITC 1356 once again emphasises the difficulties that a taxpayer will experience in demonstrating a close link between interest expenditure in respect of a loan used to purchase shares, and the income-earning operations of its own trade. It appears from this case that the acquisition of the shares in another group member must not only result in the protection or expansion of the taxpayer's own income, but that it must also be necessary for such protection or expansion of its income.

2.5.2.6 Summary

From the above-mentioned cases, it is clear that interest on loans employed to purchase shares in subsidiaries will only be allowed as a deduction in the exceptional circumstances where a sufficiently close link can be established between the interest and the taxpayer's own income-producing operations. Furthermore, the existence of such a link is a matter of fact to be determined by the circumstances of each case. The consideration of the circumstances of each case clearly involves a great deal of subjectivity, which inevitably leads to uncertainty about tax implications when acquisitions are structured. In addition, attempts to structure acquisitions in such a way that deductions may be obtained with regard to loan interest will compromise neutrality.

2.6 LOSSES ON INTRA-GROUP LOANS

2.6.1 Introduction

The deductibility or non-deductibility of losses on intra-group loans may produce tax anomalies in various instances. Section 2.6.2 will identify the anomalies that can occur when such losses are either allowed or disallowed as deductions. Section 2.6.3 will examine court cases that established the general principles concerning the deductibility of loan losses. Finally, section 2.6.4 will investigate court cases that specifically dealt with the deductibility of loan losses within a group context.

2.6.2 Possible anomalies

Assume the following information. Holdco grants a loan of R100 to Subco, its wholly owned subsidiary, and the latter applies the funds to finance expenditure that is deductible for tax purposes. From a group perspective, the loan merely serves as a mechanism to transfer funds from one legal sub-unit (Holdco) to another legal sub-unit (Subco) within the same economic entity, in order to finance group expenditure specifically incurred by the second legal sub-unit.

Subco experiences considerable financial difficulties and is consequently liquidated. If Subco utilises all its tax credits before or during liquidation (for example, if the disposal of depreciable assets leads to substantial recoupments that can absorb any assessed loss), and if a deduction is granted to Holdco in respect of the loan loss, the group will effectively obtain a R200 deduction with regard to a group outflow of R100. On the other hand, if Holdco does not receive a deduction in respect of the loan loss, the effective deduction for the group will amount to R100, which corresponds to the amount of the group's cash outflow.

If Subco cannot utilise the deduction in respect of the expenditure of R100 before or during its liquidation, no tax relief will be obtained, as Subco's assessed loss will fall away once it is wound up. If no deduction is allowed to Holdco in respect of the loan loss, the group will not

have received any tax relief with regard to the group outflow of R100. However, if a deduction is indeed allowed to Holdco, the tax deduction from a group perspective will correspond to the effective group outflow.

Thus, four possible tax alternatives exist, two of which produce anomalous results. One of these alternatives produces an unreasonable tax result from the fiscus's point of view, in the sense that a R200 deduction will be granted in respect of a R100 outflow incurred by an economic entity. The other alternative produces an unreasonable tax result from the group's point of view, as no deduction will be granted in respect of the outflow incurred by it.

2.6.3 General principles with regard to the deductibility of loan losses

There is no section in the Act which deals with loan losses in particular, and therefore such losses will therefore only qualify for deduction under section 11(a). The main hurdle that taxpayers will encounter is to demonstrate that loan losses are of a revenue nature. Most court cases with regard to the deductibility of loan losses revolve around this issue.

In *Stone v SIR* (1974), the Court, in determining whether a loan loss was of a capital or revenue nature, referred to *CIR v George Forest Timber Co* and *CIR v New State Areas Ltd* (which were discussed in section 2.2.5.2). Both cases explained the distinction between revenue and capital expenditure and the further distinction between fixed and floating capital expenditure. Applying the principles formulated in those cases, the Court held that in the ordinary case of a loan of money, the capital lent constitutes fixed capital. However, it accepted the decisions reached in other cases that loan losses sustained by a moneylender are deductible, because the capital employed by him to make such loans constitutes his circulating or floating capital which is constantly turned over at a profit.

In *SIR v Crane* (1977) the meaning of the term 'moneylender' was considered. It was held by the Court that there is no universal definition of a moneylender and that the question whether a specific person is a moneylender is one of fact depending on the circumstances of the particular case. Nevertheless, certain guidelines for determining whether a person is a moneylender were

extracted from other court cases. The Court stated that it was not enough to show that a person had lent money on several occasions at remunerative rates of interest. There must be a certain degree of system and continuity about the transactions, and he must be ready and willing to lend to all and sundry provided that they are eligible from his point of view. Furthermore, the system or plan employed by the person for laying out and getting back the capital for further use should involve a frequent turnover of the capital. Finally, the obtaining of security for the capital is a usual though not an essential feature of loans made in such a business.

From the above cases, the following line of reasoning may be deduced for solving the problem of the deductibility of loan losses under section 11(a). Firstly, it must be determined whether the person making the loan is a moneylender. If so, the loss will be one of a floating capital nature. If the other requirements of section 11(a) are satisfied, the loss will be allowed as a deduction. However, from the judgement in *SIR v Crane* it is clear that establishing whether a person is a moneylender may be a challenging exercise fraught with uncertainty.

2.6.4 Deductibility of loan losses within a group context

2.6.4.1 Plate Glass and Shatterprufe Industries (Finance Company) (Pty) Ltd v SIR (1979)

Plate Glass was a subsidiary that served as the finance company of its group. Previously, each group company controlled its own funds and made its own arrangements for financial facilities. To put the financing of group companies on a sounder basis, and with a view to obtaining financial facilities on more advantageous terms, the taxpayer was formed for the purpose of administering the financial resources of the group to the best possible advantage. To that end the taxpayer borrowed money from other group companies and outside parties and lent it to group companies that required funds.

The case did not deal with the deductibility of a loss on a loan made by the taxpayer, but rather with the deductibility of a foreign exchange loss on a loan granted to the taxpayer. However, to decide whether such a loss was of a capital or revenue nature, the Court mainly focused on the

question whether the taxpayer was involved in moneylending in order to determine whether the exchange loss was a cost associated with its floating capital. The principles established in this case are therefore relevant to the matter under consideration.

It was found by the Court that Plate Glass's sole function was that of controlling and channeling funds available to the group. Reasons for this finding were that it did not lend money to borrowers outside the group and that it often lent vast amounts to fellow group companies without obtaining any security. The Court stated that the taxpayer's business operations were not directed at promoting trading operations to its own best advantage. Instead, its policy was directed by group requirements and its function was the rationalisation and redistribution of group capital to the best advantage of the group. It was therefore concluded that the taxpayer was not a moneylender in its own right.

The Court further stated that the true inquiry in such cases should be into the function of the money in the taxpayer's hands, rather than into the nature of the taxpayer's business. Nevertheless, it was remarked that the latter inquiry serves as an important guide to the former inquiry. On this basis, it was found that the money borrowed by Plate Glass did not constitute its working capital, as it was not borrowed to enable Plate Glass to trade in own right. The taxpayer merely served as a conduit for the flow of funds within the group. The fact that it was a separate juristic *persona* did not alter the character of the funds in its hands as capital raised by the group for use by companies in that group.

The Court's line of reasoning in this case appears to be extremely inequitable. In treating Plate Glass as a separate taxable entity, it emphasised legal form over economic substance. Yet, when determining the nature of the taxpayer's business and the function of the money in its hands, it emphasised economic substance over legal form by stating that the taxpayer did not trade in its own right but merely acted as a conduit of funds within the group. The Court was therefore not consistent in its approach, to the detriment of the taxpayer. It is submitted that if the Court did not switch its approach when determining the nature of the taxpayer's business and the character of the money in its hands, it would have been forced to conclude that Plate Glass did in fact trade

for its own account as a money lender, and that the money in question was borrowed for this purpose.

2.6.4.2 Solaglass Finance Company (Pty) Ltd v CIR (1991)

The taxpayer in this case was the same person as the taxpayer in the previous case. Its name was merely changed from Plate Glass and Shatterprufe to Solaglass Finance Company. In the period subsequent to the previous case, the appellant's field of activities was marginally broadened. Loans were now also made to staff members of companies within the group and bills were discounted for customers of trading subsidiaries to enable those customers to settle their accounts with such subsidiaries. The taxpayer also deposited money with building societies to enable staff members to obtain mortgage bonds. The expansion of business was therefore primarily directed at promoting the interests of group companies, and as such could be viewed as an extension of its original mandate to control and manage the financial resources of the group.

The issue at hand in this particular case was the deductibility under sections 11(a) and 23(g) of a loss incurred by the taxpayer as result of a loan to a fellow subsidiary that became irrecoverable.

With regard to section 11(a), the Court stated that if the taxpayer could show that it had been carrying on the business of moneylending, losses sustained by it as result of loans made in the course of such business becoming irrecoverable would be of a revenue nature. The Court found that the taxpayer's sole business consisted of the borrowing of money and the making of loans, albeit only to companies in the group, staff members and customers of trading subsidiaries. The taxpayer's business could therefore be described as one consisting entirely of the borrowing and lending of money at a profit. The Court remarked that certain features of the taxpayer's business were not found in an ordinary moneylending business because of the group constraints under which it operated. However, that did not preclude the taxpayer's business from being one of moneylending. The capital that became irretrievable was therefore floating capital.

The finding of the Court with regard to the nature of the taxpayer's business is in direct opposition to the finding in the Plate Glass case, although the taxpayer in both cases was the

same person and its activities had not changed materially. The conflicting findings in these cases illustrate that the outcome of a determination of a taxpayer's status as a moneylender or not can be highly unpredictable. This is to be expected when no exact definition of the term exists and when the courts subjectively apply imprecise guidelines to the circumstances of each particular case.

Although the Court found that the loss was not of a capital nature, the majority decided that section 23(g) prohibited a deduction of the loss. It should be noted that section 23(g) still existed in its unamended form at the time, and therefore stated that the loss must be incurred wholly and exclusively for the purposes of trade to be deductible. In arriving at the decision that the loss was not incurred wholly and exclusively for purposes of Solaglass's trade, the following considerations were taken into account:

- On the facts, the taxpayer's trading activities were geared to the achievement of a dual purpose, namely the making of a profit by the taxpayer as well as the furthering of the interests of other subsidiaries within the group.
- The promotion of the group's interests was an integral part of the activities carried out by the taxpayer, as its trading activities were governed by group requirements.
- The connection between the loan giving rise to the loss and the benefit to the group was both direct and immediate, and that there was a close link between the taxpayer's activities and the furthering of the group's interests. Consequently, a distinct purpose other than that of trading in its own right existed.

It is interesting to speculate about the outcome of the case if section 23(g) had already been amended at the time. If the method of apportionment employed in ITC 1037 and CIR v Sunnyside Center (Pty) Ltd. is followed, the deduction of the loan loss would probably have been limited to the net interest income derived by Solaglass from that particular loan.

In contrast to the Plate Glass case, the Court was consistent when it identified the taxable entity and considered the nature of that entity's business. Legal form was emphasised by treating Solaglass, rather than the group, as the taxable entity. The focus on legal form was maintained when the Court examined Solaglass's activities and found that it was involved in moneylending,

irrespective of the fact that the moneylending operations were predominantly carried out within group context. However, in its application of section 23(g), the majority of the Court shifted its emphasis from form to substance by venturing beyond the boundaries of the taxpayer's separate legal *persona* into the economic sphere of the group, and by finding that the activities of the taxpayer were partially aimed at promoting the interests of this economic sphere. This inconsistency of focus, which can also be found in other cases that dealt with the application of the trade test of sections 11(a) and 23(g) to intra-group transactions, is highly unsatisfactory.

2.6.4.3 Summary

The deductibility of loan losses creates a fair amount of uncertainty. Although it was laid down in several court cases that losses will be of a revenue nature if it is determined that the taxpayer is a moneylender, the guidelines for such determination and their application to the facts of a particular case are by no means cast in stone. Furthermore, the issue is complicated within a group context by the trade requirement of section 23(g), which may operate to the detriment of a group financing company whose moneylending activities are dictated by group policy.

Because the deductibility of intra-group loan losses is considered independently of any tax relief obtained with regard to the expenditure financed by the loan proceeds, and because the deductibility of such loan losses is highly unpredictable, the anomalies referred to in section 2.6.2 occur at random and therefore are not properly controlled by the present tax system.

2.7 THE EMPLOYMENT OF REALISATION COMPANIES TO DISPOSE OF ASSETS

2.7.1 Introduction

In deciding the capital or revenue nature of a receipt or an accrual, the courts have established that the intention with which an asset is acquired is not conclusive. A change in intention is also relevant in that an intention to hold an asset as an investment may be changed into an intention to engage it in a scheme of profit-making and *vice versa* (Meyerowitz, 1997: 8-12).

The realisation of an asset does not *per se* constitute a change of intention. In *CIR v Stott* (1928), Wessels JA said the following in this regard: “Every person who invested his surplus funds in land or stock or any other asset was entitled to realise such asset to the best advantage and to accommodate the asset to the exigencies of the market in which he was selling. The fact that he did so could not alter what was an investment of capital into a trade or business for earning profits.” And in *John Bell & Co (Pty) Ltd v SIR* (1976), Wessels JA further developed this principle when he stated: “... the mere change of intention to dispose of an asset hitherto held as capital does not *per se* subject the resultant profit to tax. Something more is required in order to metamorphose the character of the asset and so render the proceeds income. For example, the taxpayer must already be trading in the same or similar kinds of assets, or he then and there starts some trade or business or embarks on some scheme for selling such assets for profit, and, in either case, the asset in question is taken into or used as his stock-in-trade.” But the dividing line between the realisation of a capital asset to best advantage and a change of intention invoking the use of or disposal of an asset as trading stock in the course of a profit-making scheme is often blurred (Meyerowitz, 1997: 8.13) In *Natal Estates Ltd v SIR* (1975), it was stated that the distinction between the two courses of action is a matter of degree depending on the circumstances of each particular case.

It is against this background that the concept of realisation companies is introduced. Such companies are formed to realise assets previously held by the companies’ promoters. A question that arises in this regard is whether a company which genuinely intends to merely realise a capital asset to best advantage, and proceeds to do so through a separate entity, will be prejudiced from a tax perspective by conducting the realisation in this manner. A further question that arises is whether a company wishing to speculatively dispose of an asset previously held by it as capital can obtain an undue tax advantage by effecting the realisation through a separate entity. These questions and other relevant issues will be examined in the ensuing sub-sections.

2.7.2 *The use of separate companies to realise capital assets*

2.7.2.1 Realisation Company v COT (1951)

The facts of the case can be summarised as follows. ‘A’ Company Ltd. was incorporated in England for the purpose of making investments. Its issued share capital was £1250 000. The value of certain of A’s investments decreased, with result that its net asset value fell below the amount of its issued capital. In view of a *dictum* laid down in an English court case, A was therefore precluded from declaring any dividends out of income derived from its successful investments. Consequently it was decided to unwind A. Its quality assets were transferred to another company in exchange for shares in that company and the shares were distributed by A to its shareholders. The depreciated assets were transferred to a realisation company in exchange for debentures, which were also distributed by A to its shareholders. The underlying rationale was that the realisation company would utilise the realised proceeds of the transferred assets to redeem the debentures.

Amongst the assets transferred to the realisation company were debentures of £60 000 in a company in liquidation. The property hypothecated to these debentures was declared executable. The realisation company purchased the property for £20 000 and sold it at a considerable profit. The issue at hand was whether the proceeds on disposal of the property were of a capital or revenue nature. It should be noted that the transaction in question was not the disposal of the transferred debentures but the disposal of the underlying property. Nevertheless, it can be said that the case effectively dealt with the disposal of the debentures, as they must have been acquired by the realisation company with the intention of realizing it at maximum value through the purchase and profitable resale of the underlying security.

The Commissioner contended that the business of the realisation company was to acquire certain assets and to sell or otherwise dispose of them as profitably as possible, and that the purchase and realisation of the property was a scheme of profit-making in the ordinary course of its business. Beadle J responded as follows to this contention: “... an examination of these ‘realisation

company' cases does seem to show that where a company is formed for a legitimate purpose unrelated to tax avoidance with the express object of realizing assets acquired at its formation from its promoter - assets which its promoter himself could have realised in similar circumstances without attracting tax, and the company does nothing more than realise those assets, then any gains made on a simple realisation of those assets would be regarded as accruals of a capital nature." By applying this principle to the facts of the case, the Court concluded that the proceeds on the disposal of the property was capital in nature.

It appears from this judgement that in the very particular circumstances described in the above quotation, the courts will look beyond the separate legal *persona* of the realisation company and will consider the economic substance of the realisation. Thus, if a company decides to sell a capital asset through a wholly owned realisation company for commercial reasons other than the obtaining of a tax advantage, the group will not be unfairly prejudiced by this particular mode of disposal. However, when a separate entity is employed to realise a capital asset, care must be taken to comply with all the requirements stated by Beadle J, or disastrous tax effects may result. The following case is an illustration in point.

2.7.2.2 Overseas Trust Corporation Ltd v CIR (1926)

The Overseas Trust Corporation was an investment company that carried on the business of buying and selling shares with the view to profit from such dealings. The company had been formed to take over the interests of one L, who held 97% of the shares of the company. Although the case did not deal with a holding company using a subsidiary to realise an asset, the principles established and confirmed therein are nevertheless applicable to all realisation company situations, including those that exist within group context.

For reasons not known to the Court, L had sold his interests to the company at less than half of their market value. Among the assets acquired from L were certain shareholdings in companies which had formerly carried on business in the Territory of South West Africa, but had been placed in liquidation prior to the formation of Overseas Trust. At the date of transfer of these shareholdings, there remained in the hands of the Custodian of Enemy Property for the Territory

certain sums due to be paid to the shareholders of these companies. On these monies being paid out by the Custodian, the amount received by Overseas Trust was largely in excess of the price paid to L for the shares. The matter to be decided by the Court was whether the proceeds received by Overseas Trust was of a revenue or capital nature.

In delivering judgement the Court stated that the character that the money would have possessed in the hands of L was not relevant to the issue at hand. The following was said in this regard by Innes CJ: "The court was concerned with the position of the appellant, not with what would, under other circumstances, have been the position of the vendor. He had promoted and formed the company for his own convenience; by the transfer of those assets to it, on the basis on which that transfer had been arranged, a new position had been created which might be inconvenient but must be accepted. In the words of the President of the Special Court, 'neither Dr. Lubbe nor the company can escape the consequences involved by the creation of a distinct *persona*.'" The Court found that as the company was an investment dealing company that bought shares with the view of selling them at a profit, the amount received by Overseas Trust represented a gain made by an operation of business in carrying out a scheme of profit-making, and that it was therefore of a revenue nature.

The Overseas Trust Corporation case can be distinguished from the Realisation Company case by stating that in the latter case the company was established with the express purpose of realizing a capital asset of its promoter to the best advantage, while in the former case a capital asset of the promoter was transferred to a company that speculatively traded in similar assets. Although the intention of the promoter with regard to the shares in the former case may not have changed, and although the company realised the shares in exactly the same way as the promoter would have done, the Court focused on the separate *persona* of the company and the trading activities carried out by it independently of the promoter, to decide that the realisation proceeds were of a revenue nature. When a capital asset is realised through a separate entity, extreme care must therefore be taken to ensure compliance with the requirements set out in the quotation from Realisation Company v Cot. The mere fact that a taxpayer did not change his intention with regard to a capital asset upon its transfer to another entity will not be sufficient to escape liability for tax.

2.7.2.3 Berea West Estates (Pty) Ltd. v SIR (1976)

The history of the property realised in this case is as follows. The original owner of the property, K, donated an undivided half share of it in trust to his children. By his will K donated the remaining undivided half share in the property to his children. The administration of the trust and K's estate became very difficult due to a variety of reasons. Consequently, it was decided to sell the property held by the trust and K's estate. In order to ease the realisation from an administrative perspective, the property was transferred to a company. Debentures were issued to creditors of the estate, while shares in the company were issued to the trust and K's heirs. The principal objective of the company was to realise the property to the best advantage of the shareholders after discharging all liabilities to creditors.

The company set about to actively develop the property as no seller could be found for the property *en bloc* at a reasonable price. However, no development activities were carried out other than those activities prescribed by the Private Township Board. Thus, Berea West Estates only developed the property to the extent that was necessary to market it as a township.

The Court found that Berea was indeed a realisation company with the original intention of realizing a capital asset to the best advantage of its shareholders. However, the inquiry did not stop there. In the light of the particular method of disposal, the Court further considered the possibility that it had changed its original intention and embarked upon a scheme of selling the property for a profit, thereby converting what was initially a capital asset into stock-in-trade. Referring to the sheer size of the property, the Court found that the prudent course of disposal would be to divide the property into lots. Berea was merely accommodating the property to the exigencies of the market and therefore it did not deviate from its original intention of being a realisation company.

An important point that emerges from this case is that a realisation company will not be able to trade actively in property without incurring a liability for tax merely because it is referred to as a realisation company. On the contrary, it will be subjected to the same tests that the original owner would have been subjected to if the latter had realised the asset.

2.7.3 The use of separate companies to realise assets where the intention has changed from investment to speculation

Although a realisation company will be subjected to the same tests that its promoter would have been subjected to if the latter had sold the asset, it is still possible to obtain an unjustified tax advantage through the use of a realisation company where the owner of an asset has changed his intention from investment to speculation. The reason is that a realisation company will facilitate the splitting of the total economic gain to the original owner into a non-taxable capital portion and a taxable revenue portion. An example will illustrate this statement. Assume that Holdco acquired a property for R1000 000 with the intention of deriving rental income from it and indeed employed the asset for that purpose over an extended period. Clearly Holdco had a capital motive when it acquired the property. Due to considerable development within the neighbouring area, the plot has dramatically increased in value. Unfortunately, the building does not fully exploit the potential of the plot. Holdco, realising that an opportunity for vast profit has presented itself, decides to demolish the original building and to erect an improved building on the plot, after which it will sell the property. Total demolition and construction costs will amount to R5 000 000 and it is estimated that the property can be sold for R15 000 000 shortly after completion of the development work.

If Holdco decides to develop the property itself, its change of intention concerning the property will convert what was previously a capital asset into stock-in-trade. The proceeds on disposal of R15 000 000 will be included in the gross income of Holdco, the demolition and construction costs of R5 000 000 will be deducted under section 11(a), and the original purchase price of R1 000 000 will be deducted under section 22(2). The net tax result is an increase in Holdco's taxable income of R9 000 000.

However, Holdco may decide to form a wholly owned subsidiary to develop the property, or otherwise the property may be transferred to an existing wholly owned subsidiary for such purposes. If the property is sold to the subsidiary at its current market value of (say) R8 000 000, the proceeds will not be included in Holdco's gross income, because it has merely realised a capital asset. Subco will have to include the R15 000 000 selling price of the developed property

in its gross income, but it will be entitled to deductions in respect of the demolition and construction costs of R5 000 000 as well as the purchase price of R8 000 000.

The tax result of this arrangement from a group perspective will be an increase in taxable income of only R2 000 000. If sound commercial reasons can be advanced for structuring the disposal in this way, the Commissioner of Inland Revenue will not be able to invoke the provisions of section 103(1) (refer to section 2.12.1).

It should be noted that the above-mentioned opportunity for tax avoidance is not restricted to groups. It is perfectly possible for a natural person to employ a realisation company in the above-mentioned way to minimise his tax liability. However, a group taxation system that disregards the legal boundaries between separate group companies, such as a consolidation system, will prevent such tax avoidance with regard to groups.

The utilisation of a separate entity to dispose of an asset where the intention of the original owner has changed from investment to speculation will not always produce a tax advantage. If a capital asset is disposed of to a wholly owned trading company at a price below its cost, the trading company will be taxed on a profit in excess of the net gain to the group, because a portion of the taxable revenue profit of the trading company will not be neutralised by the non-deductible capital loss of the first member. An illustration of this situation is presented below.

Holdco owns an office block, acquired at a cost of R20 000 000, as an investment property in a once fashionable city center. However, dramatic urban decay has caused occupancy levels to dwindle to uneconomic levels. Consequently, Holdco decides to dispose of the property to a wholly owned subsidiary, Subco, at its market value of R8 000 000. Subco is an established property developer that is renowned for its expertise in converting properties to other uses and the company intends to convert the office building into low-cost flats. It incurs construction costs of R5 000 000 and sells the flats to individual purchasers for a total consideration of R15 000 000. From a tax perspective Holdco will not be entitled to deduct its capital loss of R12 000 000 under section 11(a). Subco, being a separate taxable entity, will be taxed on its trading profit of R2 000 000, which represents the sales proceeds of R15 000 000 minus the

acquisition cost of R8 000 000 and the further construction costs of R5 000 000. From the group's point of view a loss of R10 000 000 is sustained, which is calculated as the sales proceeds of R15 000 000 received by Subco, minus the original acquisition cost of R20 000 000 incurred by Holdco and the construction costs of R5 000 000 incurred by Subco. However, by employing Subco to effect the disposal, the loss to the group of R10 000 000 is split into a taxable revenue profit of R2 000 000 and a non-deductible capital loss of R12 000 000.

An attempt by the group to increase the transfer price of the property to the artificial level of R20 000 000 so that Holdco will not sustain a capital loss while Subco will incur a revenue loss of R10 000 000, may result in an application of section 103(1).

Had Subco been a division of Holdco, instead of separate company, it would have been possible to argue that Holdco had changed its intention with regard to the office block, and converted a capital asset into stock-in-trade. Consequently, Holdco would be entitled to a deduction of the original acquisition cost of R20 000 000 and the tax result would be harmony with the economic loss sustained.

2.7.4 Conclusion

Where a separate company is employed merely to realise a capital asset of the original owner to the best advantage, unfavourable tax anomalies will not arise on condition that the requirements laid down in *Realisation Co v COT* are satisfied. However, where a separate company is utilised to realise an asset in respect of which the intention has changed from investment to speculation, tax anomalies which are favourable to groups may arise due to the artificial dissection of the total gain or loss into separate capital and revenue portions.

2.8 INTRA-GROUP TRANSFER OF REVENUE ASSETS WHICH ARE SUBSEQUENTLY HELD AS CAPITAL

2.8.1 Introduction

Where a group company profitably disposes of a revenue asset to another group company, which is subsequently held by the latter as a capital asset, tax results may arise which differ from the results that would have arisen if the asset was transferred between divisions of the same company. In this regard, it is necessary to distinguish between two scenarios.

In the first scenario an asset is acquired by a group company trading in similar assets, but with the express purpose of transferring it to another group company that intends to employ the asset as fixed capital. The equivalent of this scenario within a divisionalised company is one where such a company acquires an asset with an investment intention and utilises it in accordance with that intention.

In the second scenario an asset is acquired by one group company trading in similar assets with the intention that the asset will serve as its stock-in-trade. It is subsequently transferred to another group company, which intends to employ the asset as fixed capital. The equivalent of this scenario within a divisionalised company is one where such a company changes its intention with regard to an asset from speculation to investment.

The two scenarios and their equivalents within divisionalised companies will be illustrated in section 2.8.2 and 2.8.3 respectively.

2.8.2 Asset acquired by a trading entity with the express purpose of transferring it to another entity, which will use it as fixed capital

Assume that Subco, an 80% subsidiary trading in property, acquires an office building at a 'wholesale' price of R9 000 000 and immediately sells it to Holdco at a 'retail price' of

R10 000 000. Holdco intends to occupy the property for trade purposes. The group will effectively be taxed on a profit of R1 000 000, although in substance it has merely acquired a capital asset at a cost of R9 000 000. If Subco had been a division of Holdco, the initial purchase of the building would be viewed as the acquisition of a capital asset, and the transfer between the divisions would have no effect on the taxable income of the company.

It should be noted that when an office building is employed as a capital asset, no allowances will be granted in respect of its cost. Where the asset transferred between group companies is deductible manufacturing equipment, for example, the tax implications of the transfer will differ, but will nevertheless be anomalous. The profit made by the trading company upon the transfer of the equipment will be taxed immediately. Although this profit inflates the purchasing company's cost of acquisition on which deductions will be granted under section 12C, the deductions will be spread over an extended period. A timing disadvantage will therefore occur in respect of the tax cash flows arising from the transfer. On the other hand, where a trading division of a company purchases machinery for a manufacturing division, which is to be used by the latter as a capital asset, the transfer of the machinery will attract no tax consequences, even if the trading company earns an internal profit from the transfer. The company's intention with the acquisition of the machinery will be one of investment, irrespective of the fact that the machinery was procured by a trading division of the company. The deductions in respect of the machinery will be based on the original purchase price, and not the transfer price between the divisions. No timing disadvantage will therefore arise, in the sense that the internal profit will be taxed immediately, while deductions in respect thereof will only be granted over an extended period.

An example will serve to quantify the disadvantageous timing of cash flows explained above. Assume that Subco, a trader in manufacturing equipment, acquires machinery at a wholesale price of R200 000 and immediately transfers it to Holdco at a retail price of R300 000. The latter employs it in a process of manufacture. Table 2.4 illustrates the tax cash flows in respect of the transaction under the assumption that Subco is a wholly owned subsidiary of Holdco, while table 2.5 illustrates the tax cash flows under the assumption that Subco is a trading division of Holdco.

Table 2.4

Tax cash flows in respect of machinery transferred between entities and subsequently held as capital, assuming that they are separate group companies

	Year 1	Year 2	Year 3
Tax on profit made by Subco	(30 000) (1)	-	-
Tax relief in respect of cost of machinery to Holdco	30 000 (2)	30 000	30 000
Net tax cash flows	-	30 000	30 000

(1) $(300\,000 - 200\,000) \times 30\%$

(2) $300\,000 / 3 \times 30\%$

Applying a weighted average cost of capital of 20% to the net tax cash flows above, a present value of R38 194 at the beginning of year 1 is obtained.

Table 2.5

Tax cash flows in respect of machinery transferred between entities and subsequently held as capital, assuming that they are divisions of the same company

	Year 1	Year 2	Year 3
Tax on profit made by Subco	-	-	-
Tax relief in respect of cost of machinery to Holdco	20 000 (1)	20 000	20 000
Net tax cash flows	20 000	20 000	20 000

(1) $200\,000 / 3 * 30\%$

Applying a weighted average cost of capital of 20% to the net tax cash flows above, a present value of R42 130 is obtained, which is R3 936 more favourable than the present value of R38 194 in the case where Subco and Holdco are group companies.

It may be argued that identical present values can be obtained if Holdco, instead of Subco, purchases the machinery at its wholesale price. However, this may not be possible in practice. For example, Subco may have an exclusive distribution agreement with the manufacturer of the equipment, or it may be able to procure the equipment at wholesale prices due to bulk purchasing or long-term agreements. In such a case, it may be argued, Subco can merely transfer the equipment to Holdco at its wholesale price. However, if this cost is substantially below the normal selling price, the arrangement may be susceptible to an attack under section 103(1).

2.8.3 Asset acquired by a trading entity as stock-in-trade and subsequently transferred to another entity which will use it as fixed capital

If a trading company acquires an asset with the intention to hold it as stock-in-trade, and subsequently transfers it to another company within the group that utilises it as fixed capital, the tax consequences will be identical to the tax consequences described in section 2.8.2 with regard to groups.

If the trading entity is a division of the company to which the asset is transferred, the tax consequences will differ from the tax consequences described in section 2.8.2 with regard to divisionalised companies. In such an instance, the tax effects of the transfer will be determined by section 22(8) of the Act. According to that section, if a taxpayer has applied any trading stock for any purpose other than the disposal thereof in the ordinary course of his trade and the cost price of such trading stock has been taken into account in the determination of the taxable income for any year of assessment, the taxpayer shall be deemed to have recovered or recouped an amount equal to the market value of such trading stock, and such amount shall be included in his income for the year of assessment in which the trading stock was so applied. Where an asset consisting of trading stock so applied is used or consumed by the taxpayer in carrying on his trade, the amount included in his income shall for the purposes of the Act be deemed to be expenditure incurred in respect of the acquisition by him of the asset. Thus, the internal profit upon the transfer of the asset will be taxed, but it will form part of the deemed cost of the asset on which deductions, if applicable, will be granted. The tax consequences of an intra-divisional transfer of assets and the tax consequences of an intra-group transfer of assets will therefore be identical if the circumstances described in this section prevail.

Although equitable tax treatment is achieved between groups and divisionalised companies in the circumstances described in this section, it should be noted that inequitable tax results still arise in the circumstances described in section 2.8.2.

2.9 INTRA-GROUP LEASE PREMIUMS

Paragraph f of the definition of gross income in section 1 of the Act specifically includes in gross income any amount received or accrued from another person as premium or like consideration for the use or right of use of certain specified properties. It should be noted that the full amount of the premium must be included in gross income in the year of assessment in which it is received by or accrues to a person.

Section 11(f) of the Act provides for an allowance in respect of any premium or consideration in the nature of a premium paid by a taxpayer for the use or right of use of certain specified properties. The deductions are spread over the period of the lease or twenty-five years, whichever is less. Furthermore, no deduction will be allowed in any year of assessment if the leased property is not used in the production of the lessee's income or if no income is derived from it.

The application of the above-mentioned provisions to intra-group lease premiums produces a negative net present value of group tax cash flows despite the fact that no net operational cash flow occurs from a group perspective. An example will illustrate this statement. Assume that Holdco owns 100% of the shares in Subco. A contract of lease is entered into between the two companies in terms of which Holdco will lease an asset from Subco for a period of ten years. A premium of R10 000 is payable by Holdco at the commencement of the lease. The group cash flow in respect of the premium is zero, as Holdco pays an amount of R10 000 to its wholly owned subsidiary. However, the resultant tax cash flows produce a negative net present value because of the immediate inclusion of the R10 000 in Subco's gross income, while the deduction of this amount to Holdco is allowed in ten annual installments of R1 000. Assuming that tax cash flows arise at the end of each year of assessment, Subco will pay tax of R3 000 ($R10\,000 \times 30\%$) at the end of the first year, while Holdco will receive tax relief of R300 ($R1\,000 \times 30\%$) at the end of the first to tenth year of assessment. Applying a weighted average cost of capital of 20% to these tax cash flows, a negative net present value of R1 242 is obtained at the beginning of year 1.

If Holdco decides to withdraw the asset from use at the end of year two, an even less favourable net present value of tax cash flows will be produced. Because the asset is no longer used in the production of Holdco's income from thereon, Holdco will not obtain any further allowances. The entire premium is still included in Subco's gross income, but Holdco will only be able to deduct 20% of the premium. Thus, Subco will pay tax of R3 500 at the end of the first year, while Holdco will receive tax relief of R350 at the end of the first and second year of assessment. Again applying a discount rate of 20% to these cash flows, a negative net present value of R2 382 is obtained.

In the case of a divisionalised company, where an asset 'owned' by one division is temporarily transferred to another division, no tax implications will arise as a consequence of the transfer. Again, the differing tax treatment of groups and divisionalised companies produces inequities.

To avoid the anomalous tax treatment of intra-group lease premiums in the situation where a lump sum payment is nevertheless required, the lump sum may be described as a bullet rental instead of a lease premium. A bullet rental should be deductible in full under section 11(a) during the year in which it is incurred, resulting in the simultaneous inclusion in gross income and deduction of the amount in question. However, when the definitions of lease premiums established in various court cases are examined, it becomes apparent that the distinction between bullet rentals and lease premiums is far from clear. In *CIR v Butcher Brothers (Pty) Ltd* (1945), the phrase 'premium or like consideration', as it appears in paragraph f of the definition of gross income, was defined as the consideration passing from a lessor to a lessee, whether in cash or otherwise, distinct from and in addition to, or in lieu of rent. In *CIR v Meyerson* (1947), Greenberg JA, while also considering that phrase within the context of paragraph f of the definition of gross income, stated that it was restricted to a payment over and above something else. And in *Turnbull v CIR* (1953), Centlivres JA, concerning himself with the application of section 11(f), remarked that the phrase 'premium or consideration in the nature of a premium' means a consideration in the nature of rent passing from the lessee to the lessor. The definitions established in *Meyerson* and *Turnbull* are clearly contradictory. The former provides for something over and above rent, while the latter for something in the nature of rent. The *Butcher Brothers* judgement further complicates the issue by describing a premium as a payment over and

above, or in the nature of rent. Considerable uncertainty therefore exists about the distinction between bullet rentals, which will not produce tax anomalies from a group perspective, and lease premiums, which will produce such anomalies.

2.10 INTRA-GROUP LEASEHOLD IMPROVEMENTS

According to paragraph g of the definition of gross income, if there accrues to the taxpayer, in terms of any agreement relating to the grant to any other person of the right of use or occupation of land or buildings, the right to have improvements effected on the land or to the buildings, there is included in his gross income in the year of assessment in which the right accrues –

- the amount stipulated in the agreement as the value of the improvements or as the amount to be expended on the improvements; or
- if no such amount is stipulated, an amount representing the fair and reasonable value of the improvements.

Although the section requires the inclusion of the relevant amount in gross income in the year of assessment during which the right accrues to the taxpayer (which is normally the year in which the agreement is concluded), in practice the amount is taxed in the year during which the improvements are completed (Huxham and Haupt, 1997: 147). It should be noted that the entire amount of the improvements must be included in gross income during that year, and that no provision is made for the spreading of this amount over the remaining period of the lease.

A corresponding allowance is granted by section 11(g) of the Act. That section allows the deduction of expenditure actually incurred by the taxpayer in pursuance of the obligation to effect improvements on land or to buildings under an agreement whereby the right of use or occupation of the land or buildings is granted by any other person. The allowance is spread over twenty-five years or the period remaining of the lease at the time of completion of the improvements, whichever is the lesser. Furthermore, the allowance is not granted in any year of assessment in which the land or buildings are not occupied for the production of income, or in which no income is derived from them.

Tax anomalies similar to those discussed in section 2.9 (intra-group lease premiums) will occur in the instance where a lease contract providing for improvements to be effected by the lessee, is concluded between group companies. Again, the reasons for these anomalies are, firstly, that the entire amount of the improvements is included in the lessor's gross income when they are completed, while the deductions granted to the lessor are spread over the remaining period of the lease, and, secondly, that the total amount of the improvements may not be allowed as a deduction to the lessee if the leased property is withdrawn from use by the lessee before expiry of the lease term.

Further anomalies may occur in the case of leasehold improvements due to certain features peculiar to paragraph g of the definition of gross income and section 11(g). The first of these anomalies arises when an amount is stipulated in the lease agreement as the value or cost of the improvements, and the lessee spends a smaller amount. According to a strict interpretation of paragraph g of the definition of gross income, the lessor must nevertheless include the amount stipulated in the agreement in his gross income, while section 11(g) only allows deductions in respect of the costs actually incurred by the lessee. A situation is therefore created where the gross income of the lessor will be greater than the deductions of the lessee, thereby increasing the magnitude of the negative net present value of the group's tax cash flows.

The second anomaly arises when an amount is stipulated in the agreement, and the lessee voluntarily spends an additional amount. In such a case, the amount that will be included in the lessor's gross income is still the amount stipulated in the agreement. Ordinarily, the lessee will not be entitled to a section 11(g) allowance in respect of the excess amount, as it will not have been incurred in discharging the obligation placed upon it. However, the excess cost of the building so erected or improved may qualify for deductions under section 11(t) (expenditure on housing for employees), section 13 (expenditure on industrial buildings) and/or section 13ter (expenditure on residential housing). The total allowances of the lessor will therefore be greater than the gross income of the lessee. Interestingly, this anomaly may lead to the more equitable tax treatment of groups relative to divisionalised companies, by reducing or even eliminating the negative net present value of the group's resultant tax cash flows.

In the case of divisionalised companies the comparable situation with regard to leasehold improvements will be where one division temporarily uses land or buildings 'owned' by another division, and employs its own divisional cash flow to effect improvements to that land or buildings. If the improvements do not qualify for any allowances, there will be no tax implications. Because the arrangement does not attract any tax consequences, the net present value of incremental tax cash flows will be zero. If the improvements qualify for deductions under (say) section 13, the tax relief so obtained by the company will result in a positive net present value of incremental tax cash flows. When the zero or positive net present value in the case of a divisionalised structure is compared to negative net present value in the case of a group structure, it is again obvious that the present tax system does not achieve equity between these structures.

Where any premium or like consideration or any improvements to leased property are included in the lessor's income, section 11(h) provides for a deduction against the amount so included as the Commissioner deems reasonable. The Commissioner therefore has discretionary powers in this regard, and he will generally not allow a deduction in respect of lease premiums. With regard to lease improvements, the amount of the allowance is determined as the difference between the amount of the accrual and its present value discounted over the period of the lease taken into account for the purpose of determining the lessee's yearly deduction and adjusted according to the particular circumstances, if any (Meyerowitz, 1997: 12-32).

However, no deduction is permitted to the taxpayer in respect of a right to improvements if –

- the taxpayer or the lessee is a company and the lessee or the taxpayer, as the case may be, is effectively interested in more than 50% of any class of shares issued by the company, whether directly as a shareholder, or indirectly as a shareholder in any other company; or
- both the taxpayer and the lessee are companies and any third person is effectively interested in more than 50% of any class of shares issued by one of those companies and in more than 50% of any class of shares issued by the other company, whether directly as a shareholder in the company by which the shares were issued or indirectly as a shareholder in any other company.

The relationships described above include the relationships which exist within a closely held group, with result that the section 11(h) allowance will not be granted where the improvements are effected by one group company to another's property. The irony in this situation cannot be escaped: an allowance which would counter the anomaly of negative net present values in respect of tax cash flows arising from intra-group leasehold improvements is prohibited because the lease agreement is concluded between group members.

2.11 THE APPLICATION OF SECTION 24J TO INSTRUMENTS TRANSFERRED BETWEEN GROUP MEMBERS

2.11.1 Introduction

Section 24J was introduced into the Act mainly for two reasons. The first is to provide for synchronisation between the time when interest is incurred for purposes of section 11(a) and the time when interest is accrued for purposes of the definition of gross income in section 1 (Meyerowitz, 1997: 13-27), thereby preventing instances where the issuer of an instrument claims a deduction of interest in one year of assessment on the grounds that it is incurred by him in that year, while the holder of the instrument includes the interest in his gross income in a later year of assessment on the grounds that it accrues to him in that year.

The second reason for section 24J's existence is to expand the meaning of interest to include related finance charges, discounts and premiums. In this way capital/revenue mismatches are prevented with regard to amounts that represent interest in substance. For example, a loan can be granted on condition that the capital amount thereof must be repaid with a premium. Before the introduction of section 24J, the grantor of the loan may have argued that the premium was of a capital nature, while the grantee may have argued that the premium was of a revenue nature, as the payment thereof secured no enduring benefit.

By preventing timing differences with regard to the incurral and accrual of interest, as well as capital/revenue mismatches with regard to amounts that constitute interest in substance, section 24J represents a significant improvement over the situation that existed prior to its introduction.

However, an examination of its operation will reveal that new anomalies have been created which are especially glaring within a group context.

2.11.2 Operation of section 24J and the anomalies created thereby

The operation of section 24J will not be discussed extensively in this work. Suffice to say that it mainly governs the incurral and accrual of interest, by applying a yield to maturity to the initial or adjusted initial amount of an instrument. The yield to maturity represents the internal rate of return of the cash flows associated with the instrument. Instruments, in relation to companies, are defined in very broad terms to include all interest-bearing arrangements.

When an instrument is transferred between group companies, certain tax anomalies may arise. Section 24J(4) governs the incurral of an adjusted loss and the accrual of an adjusted gain on the transfer of an instrument, but does not determine the capital or revenue nature of such a loss or gain. The latter issue is still dealt with under the definition of gross income in section 1 and the general deduction formula in section 11(a), according to the principles established by the courts. Consequently, capital/revenue mismatches may still occur, as will be illustrated by the following examples.

Assume that Holdco grants a loan of R100 000 to X, an unrelated party, at the end of year 0. Interest of R5 000 will be payable at the end of year 1 and year 2, while the loan will be redeemed by a payment of R110 000 at the end of year 2. Holdco's cash flows in respect of the instrument are presented in Table 2.6, assuming that the instrument is held until maturity.

Table 2.6

Cash flows in respect of section 24J instrument to Holdco, assuming that the instrument is held to maturity

	Year 0	Year 1	Year 2
Amount	(100 000)	5 000	115 000

The yield to maturity equals 9,7672%, and the amortisation of cash inflows is presented in Table 2.7.

Table 2.7

Amortisation of cash flows in respect of section 24J instrument

	Payment	Interest portion	Capital portion	Capital outstanding
Year 0	-	-	-	100 000
Year 1	(5 000)	9 767	4 767	104 767
Year 2	(115 000)	10 233	(104 767)	-

The application of section 24J has the effect of deeming R9 767 of interest to accrue to Holdco in year 1, and deeming R10 233 to accrue in year 2. The total amount of interest accrued is R20 000, which equals the net cash inflow to Holdco.

Assume, now, that Holdco decides to transfer the instrument to a wholly owned subsidiary, Subco, at the end of year 1. If the instrument is transferred at a price ranging from R100 000 to R104 767, the difference between the price and the adjusted capital amount of R104 767 will constitute a loss that is specifically deductible under section 24J(4A)(i), the reason being that interest of R4 767 has been deemed to accrue to Holdco in year 1, while the net cash gain in respect of the instrument is less than that amount. For example, if the transfer price is R102 000,

the adjusted loss will equal R2 767 (R104 767 – R102 000). The net increase in Holdco's taxable income will therefore amount to R7 000 (R9 767 – R2 767), which corresponds to the net cash gain.

Where the transfer price is below R100 000 or above R104 767, section 24J(4A)(i) does not explicitly govern the deductibility of the adjusted loss below R100 000 or the adjusted gain above R104 767. Section 24J(4) merely states that such loss or gain shall be deemed to have been incurred by or accrued to the taxpayer in the year of transfer, which is year 1. The capital or revenue nature of the loss or gain must still be determined in accordance with the principles established by the courts.

If Holdco is not a trader in the instrument that is transferred, the loss or gain referred to in the preceding paragraph will be of a capital nature and therefore not deductible or taxable. Assume, for example that the instrument is transferred to Subco at a price of R108 000. The adjusted gain on transfer is R3 233 (R108 000 – R104 767), and although it is deemed to accrue to Holdco in year 1, the gain will not be included in Holdco's gross income because of its capital nature.

The cash flows in respect of the instrument with regard to Holdco, Subco and the group are presented in Table 2.8.

Table 2.8

Cash flows in respect of section 24J instrument with regard to Holdco, Subco and the group, assuming that it is transferred at the end of year 1 at a price of R108 000

Holdco:

	Year 0	Year 1	Year 2
Cash flow	(100 000)	113 000	-

Subco:

	Year 0	Year 1	Year 2
Cash flow	-	(108 000)	(115 000)

Group:

	Year 0	Year 1	Year 2
Cash flow	(100 000)	(5 000)	(115 000)

The yield to maturity of the instrument in Subco's hands is 6,4818%. The amount of interest deemed to accrue to Subco in year 2 equals R7 000 ($108\,000 \times 6.4818\%$), which corresponds to Subco's net cash gain of R7 000.

From a group perspective, the cash flows in respect of the instrument are the same whether it is transferred or not, because the receipt of the R108 000 by Holdco is cancelled by the payment of R108 000 by Subco. Nevertheless, the intra-group transfer will reduce the incremental taxable income in respect of the instrument from R20 000 ($R9\,767 + R10\,233$) to R16 767 ($R9\,767 + R7\,000$). The difference of R3 233 represents the capital gain made by Holdco on the transfer of the instrument to Subco. The scheme should escape an application of section 103(1) if the transfer occurs at market value and if a *bona fide* business purpose other than the obtaining of a tax benefit can be demonstrated. For example, it may be argued that the transfer was effected to alleviate cash flow problems experienced by Holdco.

If a group company is the issuer of an instrument, instead of its holder, a similar tax advantage can be obtained by transferring the instrument to another member of the group. Assume the same information as in the above-mentioned example, except that Holdco issues the instrument to an unrelated party, and that the liability is transferred to Subco at the end of year 1, with Holdco paying an amount of R98 000 to Subco in return. Holdco will be deemed to incur interest of R9 767 in year 1, while an adjusted gain on transfer of R6 767 ($R104\,767 - R98\,000$) will be deemed to accrue to it in that year. A portion of this gain, namely R4 767 ($R104\,767 - R100\,000$), will be included in Holdco's gross income under section 24J(4A)(ii), as this represents the amount of interest deemed to be incurred by Holdco under section 24J(2), which will never be paid by it as result of the transfer. If Holdco is not a dealer in the transferred instrument, the remaining portion of the gain will be capital in nature and therefore not taxable.

Subco will experience a cash inflow of R98 000 in respect of the instrument at the end of year 1 and a cash outflow of R115 000 at the end of year 2. The yield to maturity of the instrument in Subco's hands will be 17,3469% and the interest deemed to be incurred by it in year 2 will equal R17 000 ($R98\,000 * 17,3469\%$). This corresponds to Subco's net cash loss in respect of the instrument. Again, the group's cash flows in respect of the instrument are not affected by its transfer between the companies. Nevertheless, because the instrument has been transferred, the net deduction of the group amounts to R22 000 ($R9\,767 - R4\,767 + R17\,000$) instead of R20 000 ($R9\,767 + R10\,233$). The reason is that a capital gain in the hands of Holdco is treated as a deductible expense in the hands of Subco.

It should be noted that the transfer of instruments between group members that do not trade in such instruments could also produce unfavourable tax effects. This will happen when the holder of an instrument transfers it at a price below the initial amount, resulting in a capital loss which will be treated as interest income in the hands of the transferee. Similarly, unfavourable tax effects will be produced when the issuer of an instrument transfers it for compensation in excess of the adjusted initial amount, resulting in a capital loss that will effectively be excluded from the calculation of the transferee's interest expenditure.

The transfer of instruments between group members may therefore result in favourable or unfavourable tax effects, depending on the amount at which the instruments are transferred. On the other hand, the transfer of instruments between different operating divisions of a divisionalised company will produce no tax consequences.

2.12 THE SHIFTING OF INCOME BETWEEN COMPANIES TO UTILISE ASSESSED LOSSES

2.12.1 Introduction

A divisionalised company will not experience difficulty in transferring an assessed loss from one branch of activity to another. In fact, section 20(1)(b) of the Act specifically states that a person shall set off an assessed loss incurred by him in carrying on a trade in the Republic against income derived from another trade carried on within the Republic to determine his taxable income for a year of assessment.

On the other hand, if each of the trades is located in a separate group company, it may be difficult to utilise one company's assessed loss by transferring income from another company within the group. A deduction may not be allowed under sections 11(a) and 23(g) in respect of expenditure incurred by a profitable group company as result of a transfer arrangement. In addition, section 103(2) may prohibit the set off of a group company's assessed loss against the income that accrues to it as result of such an arrangement. It is therefore necessary to examine the operation of sections 11(a), 23(g) and 103(2) within the context of intra-group income transfers to determine whether groups can effectively set off assessed losses against income on a group-wide basis. If this is found not to be the case, the conclusion can be reached that equity does not exist between groups and divisionalised companies with regard to the utilisation of assessed losses.

2.12.2 Sections 11(a) and 23(g)

2.12.2.1 Introduction

The deductibility of expenditure under sections 11(a) and 23(g) with regard to intra-group transactions in general has already been discussed. From that discussion, it is clear that expenditure with regard to an intra-group transaction will only be deductible to the extent that it relates to the trade of the particular group company incurring the expenditure. This principle is relevant whether an intra-group transaction is entered into for *bona fide* purposes other than the obtaining of a tax benefit, or whether an intra-group transaction is entered into with the express purpose of transferring income to a group company with an assessed loss in an attempt to accelerate the utilisation of that loss.

Where income is transferred between group companies with the express purpose of accelerating the utilisation of assessed losses, the amount of the expenditure incurred by the profitable group company under the transfer arrangement may be excessive. As the deductibility of excessive expenditure under sections 11(a) and 23(g) has not yet been discussed, this section will address the issue by examining relevant court cases.

2.12.2.2 ITC 567 (1944)

ITC 567 dealt with the deductibility of interest paid by a company to its shareholders. The company in question admitted that the sole reason why interest was charged on shareholders' loans was to diminish its tax liability. As this case considered the deductibility of expenditure aimed at shifting income between taxable entities, the principles established therein are relevant for purposes of this study, although the transaction was not concluded between group members.

The facts of the case were as follow. The company in question borrowed substantial amounts from its shareholders and initially no interest was charged on the loans. During the 1943 year of assessment it was decided that interest of 8% should be credited to shareholders in respect of

their loans to the company. The Commissioner disallowed a deduction of interest in excess of 6%, which was considered a fair rate by him, on the grounds that the excess interest was not expended in the production of the company's income and furthermore was not wholly and exclusively laid out for the company's trade.

The Court stated that it is essential to ascertain the purpose for which expenditure is incurred, as laid down in *Port Elizabeth Electric Tramways*. Ordinarily, when money is borrowed for the purpose of investment in the taxpayer's business, the interest he pays represents expenditure incurred in keeping the loan afloat. However, the Court referred to the fact that the shareholder's loans in the case under consideration did not carry interest for a considerable period. Furthermore, there was no evidence of a contract or agreement between the shareholders and the company to the effect that the money would only continue to remain on loan in the future if interest was paid on it. The Court found that the dominant purpose of the interest was to reduce the taxable income of the company, a fact that was frankly admitted by the company. Consequently, it could not be said that the interest was incurred in the production of the company's income, and that it was laid out wholly and exclusively for purposes of its trade. The Court was of the opinion that the whole amount of the interest should have been disallowed as a deduction, but nevertheless confirmed the assessment of the Commissioner, which only disallowed the interest in excess of 6%.

From this case the conclusion can be drawn that expenditure incurred by a group company will not be in the production of its income derived from trade, if the purpose of such expenditure is to secure a tax benefit for the group.

2.12.2.3 ITC 621 (1946)

The taxpayer in ITC 621 sought to deduct a sum of £500, which was paid for the insertion of an advertisement in a souvenir programme of a public event. The Commissioner, being of the opinion that a portion of the £500 was not expenditure incurred in the production of the taxpayer's income and was not laid out wholly and exclusively for the purposes of its trade, disallowed £440 of the total amount as a deduction.

The Court considered the application of the following dictum formulated by Watermeyer AJP in *Port Elizabeth Electric Tramway Company Ltd v CIR*: "...the words of the statute (in section 11(a)) are 'actually incurred' not 'necessarily incurred'. The use of the word 'actually' as contrasted with the word 'necessarily' may widen the field of deductible expenditure. For instance, one man may conduct his business inefficiently or extravagantly, actually incurring expenses which another man does not incur; such expenses therefore are not necessary, but they are actually incurred and therefore deductible." Bearing this dictum in mind, the Court stated that it was not its function to assess what would have been a fair amount of expenditure in the circumstances. Where, however, the amount expended is such that it creates an impression upon the mind of the Court that it is an extravagant amount, the Court will enquire as to what the motives were which may have led to the expenditure. In such a case, following the usual rules, the onus will be on the taxpayer to justify the expenditure as being in total expended in the production of income and wholly and exclusively for the purposes of his trade.

Unlike the taxpayer in *ITC 567*, the company in question advanced commercial reasons for the total expenditure of £500. In attempting to prove that the amount was not extravagant, it stated that there was a paper shortage at the time and that, accordingly, advertising space was limited. Furthermore, although the rate was higher than the rate usually paid in the case of ordinary commercial publications, the event was a special occasion at which a large number of potential customers were expected to be present. The cost was therefore considered good value.

Nevertheless, the Court was unconvinced that the £500 was not extravagant in the circumstances and proceeded to raise the enquiry as to why such an extravagant amount was paid. It concluded that the company, through the medium of an advertisement, intended to contribute a gift to the cause with which the promoters of the event were concerned. The Court held that the whole amount was not expended in the production of the company's income and wholly and exclusively for the purposes of its trade. The Commissioner's assessment was therefore confirmed.

Although this case did not deal with an intra-group transaction, the principles formulated therein are nevertheless relevant with regard to techniques whereby income is transferred. Not only must

the transaction through which income is transferred be commercially justifiable, but the amount of the transaction must also be reasonable to be wholly deductible under sections 11(a) and 23(g).

2.12.2.4 ITC 1530 (1990)

The taxpayer in ITC 1530 sought to deduct interest expenditure of R3 283 236 paid to its holding company. The holding company had borrowed the money at prime and lent it to the appellant at 29,25%. During the 1985 year of assessment, when the loan was granted to the taxpayer, the average prime rate was approximately 23.2%. During the 1987 year of assessment, in which the deduction was claimed, the average prime rate was only 13,2%, providing the holding company with a profit margin of 125% on its interest expenditure. The Commissioner considered the interest incurred by the taxpayer excessive and disallowed the portion thereof in excess of 21.3% as not being in the production of income in terms of section 11(a) and as not being wholly and exclusively laid out for the purposes of trade in terms of section 23(g).

The taxpayer contended that its business was risky and that all its assets were already pledged as security for other liabilities. The directors of the taxpayer were of the opinion that it would be unable to obtain further finance elsewhere in the market and that the rate of 29,25% was therefore not excessive.

The Court referred to the fact that the taxpayer's holding company had a considerable assessed loss and stated that it was highly unlikely that the tax implications of the transaction were not taken into consideration. According to the Court, such implications must have played an important part in determining the amount of interest that was charged. Thus, the interest expenditure not only had regard to the earning of income by the taxpayer from its own trade, but it also had regard to the tax position of the group.

The Court concluded that the appellant had not discharged the onus to show that the rate of 29,25% was just and reasonable. As the Commissioner for Revenue stated that a rate of 21,3% would be acceptable and the taxpayer did not advance an alternative rate, the Court allowed a deduction of interest calculated at 21.3%.

2.12.3 Section 103(2)

2.12.3.1 Introduction

Section 103(2) of the Act comes into operation when the Commissioner is satisfied -

- that an agreement affecting a company has been entered into, or a change in shareholding of any company has been effected;
- that, as a direct or indirect result of this, income has been received by or has accrued to that company during the year of assessment; and
- that the agreement has been entered into, or the change in shareholding has been effected solely or mainly for the purpose of utilising any assessed loss or balance of assessed loss incurred by that company, in order to avoid liability on the part of that company or any other person for the payment of any tax, duty or levy on income, or to reduce the amount thereof.

If all three of the above requirements are met, the set off of any such assessed loss or balance of assessed loss against any such income shall be disallowed.

The section applies whether there has been an agreement affecting a company or a change in shareholding of that company. It is considered that a very wide interpretation must be given to the phrase “any agreement affecting any company” (Butterworths Electronic Publishers, 1996: 26.4). Thus transactions whereby income is transferred between group members should fall within the meaning of the phrase.

Generally the onus is upon a taxpayer to prove that a decision of the Commissioner is incorrect, but section 103(4) specifically deals with the matter of onus in relation to section 103(2). Section 103(4) states that whenever in proceedings relating to an appeal under that section it is proved that an agreement or change in shareholding would result in the avoidance of a person’s tax liability or in the reduction of the amount of that liability, it shall be presumed until the contrary is proved that the agreement had been entered into or the change in shareholding had been effected solely or mainly for the purpose of utilising the assessed loss or balance of assessed loss

to avoid or reduce the amount of the person's tax liability. The underlying implication is that the Commissioner must prove -

- that there was an agreement or a change in shareholding;
- that this directly or indirectly resulted in income being received by or having accrued to the company in question; and
- that the agreement or change in shareholding lead to an avoidance or reduction of the amount of a liability for tax (Butterworths Electronic Publishers, 1996: 26.6).

This affords only a small concession to the taxpayer, as the onus place upon the Commissioner relates to factual requirements that are relatively easy to prove. The issue that is usually difficult to resolve is whether the sole or main purpose of the agreement or change in shareholding was the utilisation of an assessed loss. In fact, most court cases focused on this question (Butterworths Electronic Publishers, 1996: 26.4), and the burden of proof in this regard is placed squarely on the shoulders of the taxpayer. Nevertheless, if a sound commercial purpose can be advanced for the agreement or change in shareholding, and it can be demonstrated that the existence of the assessed loss was merely incidental to that purpose, section 103(2) will not be applicable. An examination of relevant court cases will indicate the characteristics that such an agreement or change in shareholding must possess before it will escape an attack under section 103(2).

2.12.3.2 ITC 983 (1963)

The taxpayer in ITC 983 was a company that manufactured clothing, but subsequently closed down its business. It had a large accumulated assessed loss. Another company in the clothing industry experienced a significant expansion in its business and found it difficult to produce sufficient clothing to fulfil all orders. Consequently, it acquired the shares in the taxpayer company and production was recommenced on a cut, make and trim basis. Because of the recommencement of business, the taxpayer again received income, and the Commissioner disallowed the set off of its assessed loss against such income by applying section 103(2).

The Commissioner argued that the sole or main purpose of the change in shareholding of the appellant company was the utilisation of its assessed loss and referred to the following facts as motivation:

- The appellant company had a substantial assessed loss.
- It had ceased production at the time of sale and it had no employees at that time.
- The consideration paid by the purchasing company for the shares exceeded the intrinsic value of the tangible assets and therefore included an amount in respect of the assessed loss.
- The deed of sale provided for a lease of the premises on which the taxpayer conducted its business for a period of six months only.

The Court, however, considered the following factors in deciding that, although the utilisation of the taxpayer's assessed loss was a purpose of the acquisition, the main purpose was to obtain a production unit that could go into immediate operation:

- Only during negotiations for the acquisition of the taxpayer's shares did the acquiring company discover that the taxpayer had an assessed loss.
- The taxpayer owned machinery, furniture and fittings, which were installed and ready for use.
- The taxpayer occupied premises that had been approved by the authorities for use as a factory and because the premises were not for sale, the only practical alternative to secure the premises was to purchase the shares in the taxpayer.
- Although it might have been possible to secure other premises, purchase new machinery and establish a factory, such a course of action would result in long delays before production could be commenced.
- Although the purchase consideration of £2 750 exceeded the value of tangible assets by £1 750, certain valuable trade marks were also included in the purchase, and the remaining balance was not unduly large, having regard to the fact that immediate production would be possible.

From the judgement in this case it appears that if the utilisation of an acquired company's assessed loss is merely incidental to a plausible commercial purpose, section 103(2) will not be applicable.

2.12.3.3 ITC 989 (1963)

The company in question had carried on business as a timber merchant for a considerable period and incurred trading losses for several years. The total shareholding in the company was acquired by another company, whose activities consisted mainly of the manufacture of timber products. The acquiring company previously sold its products directly to builders. However, this resulted in the undercutting of timber merchants, who consequently refused to buy timber products from the acquiring company. By purchasing the taxpayer's shares, the acquiring company could channel its sales to final consumers through the taxpayer, which would enable it to sell timber to other timber merchants as well.

After the acquisition the acquiring company effected all sales of timber to builders through the taxpayer. The latter purchased timber from the acquiring company at normal wholesale prices and sold it to builders at retail prices. The Commissioner disallowed the set off of the taxpayer's assessed loss against the income so derived by it, contending that the sole or main purpose of the change in shareholding was the utilisation of the taxpayer's assessed loss.

The Court found that the main purpose of the acquisition was to obtain a separate channel through which retail sales could be effected in order to secure new wholesale outlets for the acquiring company, and to obtain other commercial benefits. It considered the following factors in arriving at this conclusion:

- The taxpayer was recognized by the Timber Merchant's Association as a timber merchant. Had the acquiring company formed a new company, it would not necessarily be recognized by the Association.
- The acquiring company provided figures substantiating its claim that wholesale sales would be increased through the separation of its wholesale and retail activities.

- The acquiring company was convinced that the taxpayer got into trading difficulties through mismanagement and that its business could be turned around. The taxpayer was therefore an attractive business prospect and would not merely serve as a vehicle for the absorption of income.
- The taxpayer had an important quota for softwoods. This would enable the acquiring company to provide its customers with their softwood needs.

Finding that the main purpose of the change in shareholding, as stated by the taxpayer, appeared reasonable, the Court held that section 103(2) did not apply to the change in shareholding.

2.12.3.4 ITC 1123 (1969)

The taxpayer in question had been engaged in the business of manufacturing, but it experienced financial difficulties and consequently went into liquidation. The liquidators systematically disposed of its assets until only the immovable property remained. R, a creditor of the taxpayer, made an offer for the property. The liquidators, however, suggested that he purchase the shares in the taxpayer instead of the property to save transfer duty and the costs of incorporating a new company to deal with the property. As a creditor of the taxpayer, R was fully aware of the taxpayer's financial position, including the existence of a considerable assessed loss, from the liquidators' documents.

Two other persons were also interested in acquiring the property and intended to make a higher offer for it. To avoid this, R accepted them as co-shareholders in the taxpayer, although it soon became apparent that the shareholders could not work together. Consequently, the other two persons purchased the property from the company. The net effect of the series of transactions was that R became the sole shareholder of the taxpayer, having paid nothing for its shares, at a time when it had no net assets, no premises and no business. However, it had a large assessed loss.

R induced the taxpayer to commence trading activities, but not as a manufacturing concern. The trading activities fell into two categories, namely (a) transactions with companies under the control of R which produced income by way of commissions, interest, administration fees and

profit on the sale of certain articles purchased from such companies, and (b) transactions with outside parties which included the buying and selling of machinery and equipment, the lending of money at interest and the discounting of bills.

The Court found that there were two changes in shareholding for the purposes of section 103(2) - namely the acquisition of the taxpayer by B and his co-shareholders, and the subsequent acquisition by B of the other shareholders' shares. During the first change of shareholding the shareholders had a dual purpose, namely to obtain control of the taxpayer's immovable property and to utilise its assessed loss by setting it off against rental income which would be produced by such property. It was not necessary to establish which of these purposes was the main purpose, because the sole purpose of the second change in shareholding was found to be the utilisation by B of the taxpayer's assessed loss.

The Court further stated that section 103(2) not only applies to income diverted from other persons, as was the case with the income derived from category (a) transactions, but also applies to income produced by the company's own activities, as was the case with the income derived from category (b) transactions. According to the Court, the wording of section 103(2) is wide enough to encompass both types of income. Moreover, if section 103(2) were to apply to diverted income only, the intention of the Legislature would have been thwarted.

2.12.3.5 Conshu (Pty) Ltd v CIR (1994)

Conshu (Pty) Ltd v CIR differs from the previous three cases discussed, as the Court considered the timing of the application of section 103(2), instead of the purpose of an agreement or change in shareholding.

The taxpayer in question conducted business as a tyre retreader and dealer. Its trade results were poor and it accumulated a substantial assessed loss. Towards the end of the 1985 year of assessment, a change in the taxpayer's shareholding occurred as part of a reorganisation of the group of which the taxpayer was a member. Furthermore, the taxpayer disposed of the bulk of its own assets and acquired all the trading assets and liabilities of another company in the group. The

result of this arrangement was that a profitable footwear enterprise was transferred to the taxpayer, which had an assessed loss and was previously engaged in an unrelated venture.

The Commissioner applied section 103(2) to disallow the set off of the taxpayer's assessed loss against income derived from the footwear business, contending that all the requirements of the section had been satisfied. The taxpayer conceded that an agreement had been entered into, resulting in income being received by or having accrued to it, and that the agreement had been entered into solely or mainly to utilise its assessed loss to avoid liability for tax. Nevertheless, the taxpayer argued that the Commissioner was not entitled to apply section 103(2) in any year of assessment following the year during which the agreement was entered into.

It should be noted that the agreement in question and the ensuing acquisition of the footwear business took place on the last day of the 1985 year of assessment, which was a Sunday. Therefore, no income could have been earned by the taxpayer because of the agreement in question during that year of assessment. Furthermore, the assessed loss at the end of that year could not be set off against such income.

The basis of the taxpayer's argument was that according to a strict interpretation of section 103(2), it only prohibits the set off of the assessed loss as contemplated in the agreement. In the case of the taxpayer, this meant the assessed loss as at the end of the 1985 year. This argument was endorsed by the minority of the Court (*Butterworths Electronic Publishers*, 1996: 26.4). However, the majority of the Court held that the wording of section 103(2) entitled the Commissioner to disallow the set off of the assessed loss in any year subsequent to the year of the agreement and that to hold otherwise would destroy the purpose of the section.

The implication of this decision is that the Commissioner is not limited to the balance of the assessed loss at the time when the agreement is entered into or the change in shareholding is effected. Should the balance of the assessed loss therefore increase in subsequent years, the increase in such balance may also be disqualified from set off against 'tainted' income (*Huxham & Haupt*, 1997: 310).

2.12.3.6 Reach of section 103(2) in practice

Interestingly, none of the above cases dealt with the situation where an agreement is entered into between existing group companies, independently of a change in shareholding, whereby income is transferred to a group company with excess deductions to avoid the visible accumulation of an assessed loss. In all of the cases that were discussed, a change in shareholding occurred. Furthermore, income was transferred to utilise assessed losses that have accumulated visibly.

The reason for this phenomenon is that a change in the shareholding of a company and the presence of a visible assessed loss are prominent signals that will alert the Commissioner to a possible application of section 103(2). On the other hand, where an existing member of a group begins to experience financial difficulties, the immediate transfer of income through intra-group transactions will absorb the excess deductions of such a member, thereby hiding the existence of an assessed loss. In these circumstances there will be no obvious warning directing the Commissioner's attention to the intra-group transfer of income.

Thus, many intra-group transfers of income which satisfy the requirements of section 103(2) may escape an attack under that section because the tax authorities are not aware of the existence of such transfers. If this is indeed the case, the conclusion can be drawn that section 103(2) is merely a theoretical risk rather than a significant practical constraint to intra-group income transfers between group companies.

2.12.4 Interaction between sections 11(a), 23(g), and section 103(2) with regard to intra-group transfers of income

As have been demonstrated in section 2.12.2 and section 2.12.3, income cannot be transferred indiscriminately between group members to accelerate the utilisation of assessed losses of certain companies. Expenditure arising from a transfer arrangement will only be deductible under sections 11(a) and 23(g) by the transferor if the expenditure is incurred for the purposes of its trade and not for purposes of group tax optimisation. Furthermore, the transferee may not set off

its assessed loss against the transferred income if the sole or main purpose of the arrangement was to avoid or reduce the amount of a tax liability through such a set off.

The interaction of sections 11(a) and 23(g) and section 103(2) with regard to intra-group transfers of income can be illustrated through an example. Assume that Holdco incurs an assessed loss of R100 for a particular year of assessment, while its wholly owned subsidiary, Subco, has taxable income of R100 for that year. In an attempt to harmonise the tax expense for the year with taxable income from a group perspective, Holdco charges an amount of R100 to Subco in respect of management services rendered during the year of assessment.

The tax positions of Holdco and Subco are presented in Table 2.9, if it is assumed that the management fee is deductible by Subco under sections 11(a) and 23(g), while section 103(2) does not prohibit the setting off of Holdco's assessed loss against the management fee.

Table 2.9

The shifting of income between group companies: tax positions of Holdco and Subco if Subco may deduct the management fee and Holdco may set off its assessed loss against such management fee

	Holdco		Subco		Group	
	Taxable income / (assessed loss)	Net profit	Taxable income / (assessed loss)	Net profit	Taxable income / (assessed loss)	Net profit
Taxable income / (assessed loss) before management fee	(100)	(100)	100	100	-	-
Management fee	100	100	(100)	(100)	-	-
Taxable income	-	-	-	-	-	-

As can be seen from the above table, the tax result from a group perspective is identical to the result that would have been obtained if the group had been a divisionalised company.

The tax positions of Holdco and Subco are presented in Table 2.10, if it is assumed that the management fee is deductible by Subco under sections 11(a) and 23(g), while section 103(2) prohibits the setting off of Holdco's assessed loss against the management fee.

Table 2.10

The shifting of income between group companies: tax positions of Holdco and Subco if Subco may deduct the management fee and Holdco may not set off its assessed loss against such management fee

	Holdco		Subco		Group	
	Taxable income / (assessed loss)	Net profit	Taxable income / (assessed loss)	Net profit	Taxable income / (assessed loss)	Net profit
Taxable income / (assessed loss) before management fee	(100)	(100)	100	100	-	-
Management fee	100	100	(100)	(100)	-	-
Unutilised assessed loss	(100)	-	-	-	(100)	-
Taxable income	100	-	-	-	100	-

As can be seen from the table, the tax result in this instance is virtually identical to the result that would have been obtained if no transfer of income had occurred between Holdco and Subco. The only difference is that Holdco instead of Subco is taxed upon an amount of R100. Thus, the transfer of income has not achieved immediate utilisation of Holdco's assessed loss.

The tax positions of Holdco and Subco are presented in Table 2.11, if it is assumed that the management fee is not deductible by Subco under sections 11(a) and 23(g), while section 103(2) does not prohibit the setting off of Holdco's assessed loss against the management fee.

Table 2.11

The shifting of income between group companies: tax positions of Holdco and Subco if Subco may not deduct the management fee and Holdco may set off its assessed loss against such management fee

	Holdco		Subco		Group	
	Taxable income / (assessed loss)	Net profit	Taxable income / (assessed loss)	Net profit	Taxable income / (assessed loss)	Net profit
Taxable income / (assessed loss) before management fee	(100)	(100)	100	100	-	-
Management fee	100	100	(-)	(100)	-	-
Taxable income / (assessed loss)	-	-	100	-	100	-

In this instance the taxable income of the group is greater than its net income, because the receipt of the management fee by Holdco has increased its taxable income, while the payment of the management fee by Subco has not decreased its taxable income commensurately. The transfer of income from Subco exhausts Holdco's assessed loss, although Subco is not granted a deduction to compensate for such exhaustion.

Finally, the tax positions of Holdco and Subco are presented in Table 2.12, if it is assumed that the management fee is not deductible by Subco under sections 11(a) and 23(g), while section 103(2) prohibits the setting off of Holdco's assessed loss against the management fee.

Table 2.12

The shifting of income between group companies: tax positions of Holdco and Subco if Subco may not deduct the management fee and Holdco may not set off its assessed loss against such management fee

	Holdco		Subco		Group	
	Taxable income / (assessed loss)	Net profit	Taxable income / (assessed loss)	Net profit	Taxable income / (assessed loss)	Net profit
Taxable income / (assessed loss) before management fee	(100)	(100)	100	100	(100) / 100	-
Management fee	100	100	(-)	(100)	100	-
Unutilised assessed loss	(100)	-		-	(100)	-
Taxable income	100	-	100	-	200	-

As can be seen from the table above, the tax result in this instance is particularly adverse. Not only is Holdco's taxable income increased without a commensurate decrease in Holdco's taxable income, but furthermore Holdco may not set off its assessed loss against the increase in its taxable income.

It is clear from the alternatives described above that the application of sections 11(a) and 23(g) as well as section 103(2) to income transfers between group companies can produce a variety of tax effects. The first alternative described above produces a tax effect similar to the effect that would have been obtained if the group had been a divisionalised company. Although equity is achieved between group structures and divisional structures in this instance, it may be at the expense of neutrality if the transfer arrangement has to be structured in a specific way to overcome the

pitfalls of section 23(g) and section 103(2). The second alternative produces a tax effect similar to the effect that would have been achieved if the transfer of income did not occur. Thus, in this instance neutrality may be compromised without achieving equity. Finally, the third and fourth alternatives produce tax effects which are not only less favourable than the effects that would have been obtained if the group was a divisionalised company, but which are also less favourable than the effects that would have been obtained if the transfer of income did not occur. The execution of a transfer arrangement may therefore involve a significant amount of risk if uncertainty exists about the possible application of sections 23(g) and 103(2).

2.12.5 Conclusion

Sections 11(a) and 23(g) as well as section 103(2) hinder the transfer of income between group members in order to accelerate the utilisation of assessed losses of specific companies. Although these hindrances can be overcome, this does not imply that assessed losses of certain group members can be indiscriminately set off against other group members' income. Consequently, equity and neutrality are compromised.

Arrangements whereby income is transferred between group companies may have other negative implications. Tax consultants and managers of enterprises expend considerable effort to plan and implement transfer arrangements which will overcome the obstacles created by sections 23(g) and 103(2). Such effort can be devoted to more productive purposes. Furthermore, transfer arrangements may interfere with measures intended to promote operational efficiency. For example, companies may be formed as autonomous units for the purposes of performance evaluation. The actual transfer of income between companies for tax purposes may affect measures of operational performance, thereby demotivating managers who are evaluated according to such measures. Finally, transfer arrangements will unfairly prejudice or benefit minority shareholders within group structures if commensurate value is not received for the transfer of income between group companies.

2.13 SECTION 103(1) AND INTRA-GROUP TRANSACTIONS

2.13.1 Introduction

Section 103(1) of the Act serves as a general anti-avoidance provision, granting specific powers to the Commissioner in relation to certain transactions, operations or schemes which have the effect of avoiding, reducing or postponing liability for the payment of tax.

The remedy available to the Commissioner under section 103(1) is to determine a person's liability for any tax, duty or levy imposed by the Income Tax Act, and the amount of that tax, duty or levy:

- as if the transaction, operation or scheme in question has not been entered into or carried out; or
- in such a manner as he deems appropriate in the circumstances of the case.

The powers described above are available to the Commissioner only when the following four requirements are satisfied:

- a transaction, operation or scheme has been entered into or carried out;
- which has the effect of avoiding, postponing liability for the payment of any tax, duty or levy imposed by the Act, or of reducing the amount thereof; and
- having regard to the circumstances under which the transaction, operation or scheme was entered into or carried out -

(i) was entered into or carried out -

(aa) in the case of a transaction, etc. in the context of business, in a manner which would not normally be employed for *bona fide* business purposes, other than the obtaining of a tax benefit; and

(bb) in the case of any other transaction, etc., being a transaction, etc not falling within the provisions of item (aa), by means of or in a manner which would not normally be employed in the entering into or carrying out of a transaction, etc. in

- the nature of the transaction, etc. in question; or
- (ii) has created rights and obligations which would not normally be created between persons dealing at arm's length under a transaction, etc. of the nature of the transaction, etc. in question; and
- was entered into or carried out solely or mainly for the purposes of obtaining a tax benefit.

Section 103(4) specifically addresses the matter of onus with regard to section 103(1). According to section 103(4), where it is proved that there is a transaction, operation or scheme which results in the avoidance, postponement or reduction of liability for the payment of tax, it is presumed until the taxpayer proves the contrary that such a transaction, operation or scheme has been entered into or carried out solely or mainly for the purpose of obtaining a tax benefit. It is therefore considered that the onus of proving the first and second requirements of section 103(1) rests with the Commissioner, and that proof of such requirements by him places the onus in respect of the fourth requirement of section 103(1) on the shoulders of the taxpayer. Moreover, since it is the Commissioner who must form an opinion as to the nature of the transaction, operation or scheme, it seems reasonable that the onus of proving the third requirement should also rest with him (Butterworths Electronic Publishers, 1996: 26.6).

2.13.2 The application of section 103(1) to intra-group transactions

2.13.2.1 Intra-group transactions entered into to avoid unfavourable tax anomalies

Group companies may specifically enter into certain intra-group transactions in order to avoid unfavourable tax anomalies. The tax effects of such intra-group transactions is therefore intended to achieve greater equity between group structures and divisional structures. However, if section 103(1) is applicable to such transactions, the tax effects which would have created a more equitable tax result will be neutralised. An example in case is ITC 1582 (1994).

ITC 1582 dealt with quantity discounts granted annually within a group, based on the sales/purchase volumes of group members. The group consisted of an ultimate holding company, E, its wholly owned subsidiaries, C and D, and C's wholly owned subsidiaries, A and B.

C manufactured certain goods, 20% of which were sold to A, a wholesaler and retailer. A sold the goods to unrelated parties in turn. The remainder of C's goods were sold to D, which provided certain services to the public. C sold its goods to A at cost price and to D at a marked-up price. At year end, C recovered an amount from A and granted a discount to D. The effect of the arrangement was to transfer income from A to D. The purpose of the transfer was to accelerate the utilisation of a large section 24C allowance available to D. Had the group been a divisionalised company, the allowance could have been utilised against its total income. It is therefore clear that the arrangement would have produced a more equitable tax result if it could escape an attack under section 103(1).

The Commissioner applied section 103(1) to the arrangement and disregarded the recovery of amounts by C from A and the granting of discounts by C to D. The appellants conceded that the first, second and fourth requirements of section 103(1) were met. The dispute therefore centered around the third requirement of section 103.

The appellants advanced the following reason for the arrangement in question: goods were sold by C to A at cost and to D at cost plus a profit margin. Because of A's varied discount policy, the possibility existed that D could obtain goods from A at lower prices than the prices charged to it by C. The companies therefore agreed that the initial prices charged by C would be preliminary prices and that adjustments would be made at year end to achieve a more reasonable result retrospectively. Consequently, an amount was recovered from A to allow C a profit on its sales to A, while a discount was granted to D to make its cost structure more competitive. A schedule of computations was presented to substantiate this claim.

The Court, after analysing the schedule, concluded that the calculations contradicted the appellants' contention, and that the amounts were calculated to enable a transfer of income from A to D. According to the Court, the true position resulting from the arrangement was that C

delivered goods to A and D without agreeing on a binding price for such goods. No contracts of purchase therefore existed. In effect, A and D sold goods that did not belong to them, the ultimate purchase price of which was indeterminable. Only at year end were purchase prices determined, not to establish reasonable transfer prices for the goods, but to achieve the most favourable tax result for the group as such. In the light of the above findings, the Court concluded that the transactions in question created rights and obligations which would not normally be created between persons dealing at arm's length. Therefore, the third requirement of section 103(1) was satisfied.

Had formal agreements been concluded between the companies before delivery of the goods commenced, which clearly stated the methods by which prices would be determined at year end, and had these methods been devised to allow all parties a reasonable profit, the arrangement would have escaped an attack under section 103(1). However, such formal and binding agreements would have resulted in a considerable loss of flexibility in transferring income between group companies, as the commercial objective of reasonable profits for all group members would not necessarily have agreed with the tax objective of optimal utilisation of available allowances.

2.13.2.2 Intra-group transactions entered into to exploit favourable tax anomalies

In the case of intra-group transactions the economic interests of separate group companies often do not conflict. Nevertheless, such transactions are tax relevant. This creates a fertile ground for the exploitation of tax avoidance opportunities which are unavailable to divisionalised companies. In the absence of specific anti-avoidance provisions section 103(1) is the only obstacle in the way of such intra-group tax avoidance. As section 103(1) is a general anti-avoidance provision, certain of its requirements are necessarily vague and subjective. This is particularly true of the third requirement, which relates to the nature of the relevant transaction, operation or scheme, and the fourth requirement, which relates to its purpose. Thus section 103(1) inevitably creates loopholes through which intra-group tax manipulations may escape.

What has been said above can be illustrated by examining an intra-group scheme which is employed to effectively obtain deductions in respect of non-deductible capital assets such as office buildings. Assume that A has two wholly owned subsidiaries, namely B and C. A wishes to acquire an office building for the accommodation of its employees. The purchase of the building at a price of R10 000 000 is effected through B, which operates as a trader in property. B grants the right of use and occupation of the building to A for a period of ten years in return for a premium of R8 000 000, which equals the present value of the estimated market rentals that would be obtainable from the property for the next ten years. Furthermore, B sells the bare dominium in the property to C at its fair value of R2 500 000. The tax implications of the transaction over the period of ten years are presented in Table 2.13.

Table 2.13**Tax implications of intra-group scheme in respect of a non-deductible office building**

	A	B	C	Group
Lease premium	(8 000 000)	8 000 000	-	-
Bare dominium	-	2 500 000	-	2 500 000
Cost of building	-	(10 000 000)	-	(10 000 000)
Net effect on taxable income	(8 000 000)	500 000	-	(7 500 000)

The tax result from a group perspective is that a net deduction of R7 500 000 will be obtained in respect of a capital asset on which no deductions would otherwise have been granted. The group exercises full ownership of the asset at all times. During the period of the lease the bare dominium vests in C, while the right of use and occupation vests in A. After expiry of the lease C becomes the full owner of the asset.

Many variations of this scheme are encountered in practice, their central theme being the conversion of the non-deductible acquisition cost of an asset into a deductible lease premium through the transfer of the asset between different taxable entities. Although such schemes may be vulnerable to an attack under section 103(1) of the Act, the possibility will always exist of structuring them in a way which will escape successful application of the said section.

Divisionalised companies cannot obtain a similar tax advantage, because transactions between divisions do not have tax consequences. Thus, by not indisputably addressing the intra-group tax manipulation discussed above, section 103(1) fails to maintain equity between groups and divisionalised companies.

2.14 CAPITAL ALLOWANCES AND THE RECOUPMENT THEREOF WITHIN A GROUP CONTEXT

2.14.1 Introduction

Allowances in respect of the cost of capital assets are granted under various sections of the Act, such as sections 11(e), 11(gA), 12B, 12C and 13. If a deductible capital asset is disposed of, and the amount realised exceeds its tax value, the difference between the amount realised (up to the original cost of the asset) and the tax value is included in gross income as a recoupment under section 8(4)(a). If, on the other hand, the amount realised on disposal is below the tax value of the asset, a scrapping allowance may be granted under section 11(o). In addition, special rules apply when certain assets are transferred between connected persons to prevent the artificial inflation of cost bases.

It is not the purpose of this section to examine the provisions relating to capital allowances in detail. Rather, the anomalies produced by these provisions within a group context, as well as certain anti-avoidance measures aimed at countering these anomalies, will be studied.

2.14.2 Anomalies favourable to groups

2.14.2.1 Inflation of cost bases and anti-avoidance measures in relation thereto

The inflation of cost bases of deductible assets can be illustrated through an example. Assume that Holdco holds an asset, acquired at a cost of R300, on which total allowances of R200 have been granted in terms of section 12C. Ignoring any relevant anti-avoidance provisions, assume further that Holdco disposes of the asset to Subco, its wholly owned subsidiary, for R600. In terms of section 8(4)(a) an amount of R200 will be recouped by Holdco. The proceeds on disposal in excess of R300 will not be included in Holdco's gross income, as the excess represents a capital profit. Subco uses the asset directly in a process of manufacture and will therefore obtain a section 12C allowance of 20% per year, based on its acquisition cost of R600. Thus, by merely transferring the asset within the economic unit of the group, a total net deduction of R600 will be obtained on an asset which cost the group R300.

However, the Act contains provisions that prevent such avoidance where certain assets are transferred between connected persons. The phrase 'connected person' is defined in section 1 of the Act. According to the definition, a connected person in relation to a company includes its holding company as defined in section 1 of the Companies Act, its subsidiary as so defined, and any other company, where both such companies are subsidiaries as so defined of the same holding company. Members of closely held groups will therefore be connected persons in relation to each other.

Sections 11(e), 11(gA), 12B and 12C contain provisions which employ the concept of connected persons to prevent tax avoidance through the manipulation of cost bases of deductible assets. Sections 11(e), 12B and 12C determine that where an allowance has previously been granted to a connected person in relation to the taxpayer, the allowances granted to the taxpayer in respect of that asset shall be based on either the cost of the asset to the taxpayer, or the market value thereof on the date of acquisition by the taxpayer, or the cost of the asset to the connected person, whichever is the lesser. It should be noted that the asset in question does not necessarily have to be acquired from the connected person. All that is required before these provisions will come into

effect is that the connected person must have obtained an allowance in respect of the asset. Section 11(gA), on the other hand, differs in this regard. Although the provision in section 11(gA) also limits the total allowances of the taxpayer to the lesser of the above-mentioned amounts, it will only come into effect if the asset in question is acquired from the connected person in relation to the taxpayer. Thus, by effecting the transfer through an intermediary, the anti-avoidance measure in section 11(gA) can be sidestepped, although an application of section 103(1) may still be possible.

Interestingly, similar anti-avoidance provisions are not found in section 13, which grants allowances on industrial buildings. Schemes aimed at the inflation of cost bases of industrial buildings are therefore only susceptible to an attack under section 103(1). As a general anti-avoidance measure with vague and subjective requirements, section 103(1) may not be as effective as the specific anti-avoidance provisions contained in the sections 11(e), 11(fA), 12B and 12C.

2.14.2.2 Acceleration of allowances through the transfer of assets between group companies

The acceleration of allowances through asset transfers can best be described by way of an example. Assume that Holdco acquires an asset costing R300. The asset qualifies for a deduction of $33\frac{1}{3}\%$ per year under section 12C. Holdco uses the asset in a process of manufacture for a period of three months during its year of assessment and then transfers the asset to Subco, its wholly owned subsidiary, at a price of R100. As the section 12C deduction is not prorated for portions of a year, Holdco will obtain a deduction of R100 under that section. If a scrapping allowance will be granted under section 11(o), Holdco will be able to deduct a further R100, representing the difference between the tax value of the asset and the amount realised on its disposal. If Subco uses the asset in a process of manufacture for the remainder of the year of assessment, it will be entitled to a deduction in terms of section 12C of R20, calculated as 20% of its acquisition cost of R100. (Because the asset is not new and unused, the section 12C allowance will not be granted at a rate of $33\frac{1}{3}\%$ per year.)

Assuming that the above scheme will not be attacked successfully under section 103(1), the group's tax cash flows in respect of the asset is presented in Table 2.14.

Table 2.14

Tax cash flows in respect of an asset transferred between group companies (scrapping allowance applicable)

	Year 1	Year 2	Year 3	Year 4	Year 5
Tax cash flow	66 (1)	6 (2)	6	6	6

(1) $[300 * 33 \frac{1}{3}\% * 30\%] + [100 * 30\%] + [100 * 20\% * 30\%]$

(2) $100 * 20\% * 30\%$

Applying a weighted average cost of capital of 20% to the cash flows in the above table, a present value of R68 is obtained.

Assumption that the asset is not transferred from Holdco to Subco, the group tax cash flows in respect of the asset is presented in Table 2.15.

Table 2.15

Tax cash flows in respect of the asset if it is not transferred between group companies

	Year 1	Year 2	Year 3
Tax cash flow	30 (1)	30	30

(1) $300 * 33 \frac{1}{3}\% * 30\%$

Applying a weighted average cost of capital of 20% to the cash flows in the above table, a present value of R63 is obtained, which is R5 less than the present value obtained if the asset is transferred from Holdco to Subco. Had the group been a divisionalised company, the intra-divisional transfer of the asset would not influence the tax cash flows in respect thereof, and the present value of such cash flows would remain R63.

It is possible that Holdco will not obtain a scrapping allowance in respect of the asset. The term 'scrapped' as used in section 11(o) is not defined in the Act, and consequently it was left to the courts to determine its meaning. Unfortunately, the courts' definition of the term is by no means robust and many aspects of it are still uncertain. For example, in ITC 657 (1948) it was held that scrapping can only apply to assets which have been worn out or have suffered physical deterioration. Nevertheless, the Court stated that the question whether an asset has been scrapped is one of degree. In this regard it referred to *Metropolitan Gas Company v Dodd* where Rowlat, J. stated that it was not necessary for something to be worn out to become obsolete, and that it could become obsolete to one person while still being useful to another. It was further held in ITC 657 that scrapping can only occur in the ordinary course of business and not on the disposal of a business. This leads one to the question whether a venture in which an asset is employed forms merely a part of a business or whether it constitutes a separate business. In the first case, assets disposed of at the termination of that venture will be disposed of in the ordinary course of business, while in the second case they will not be disposed of in the ordinary course of business. However, in ITC 769 (1953) the principle that an article can only be scrapped if the business to which it relates is still continued was questioned by De Wet, J. In an *obiter* remark, he stated that nothing in section 11(o) indicates that a scrapping must be in the ordinary course of business.

Because the meaning of the term 'scrapped' is uncertain, lucrative opportunities are created for the acceleration of allowances through the transfer of assets between group companies at prices below their tax values.

Even if an asset is transferred at its tax value, with the result that a scrapping allowance will be out of the question, it is still possible to accelerate allowances granted under section 12C. This is so because section 12C deductions are not prorated if an asset is used for only a portion of a year.

Assume that Holdco purchases an asset costing R100 at the beginning of its year of assessment. The asset qualifies for a section 12C deduction of 20% per year. If the asset is transferred to Subco after three months of use at its tax value of R80, Subco will in turn be granted a 20% allowance for the year on its cost of R80. If the scheme is not attacked under section 103(1), the group's tax cash flows in respect of the asset can be presented in Table 2.16 as follows:

Table 2.16

Tax cash flows in respect of an asset transferred between group companies (scrapping allowance not applicable)

	Year 1	Year 2	Year 3	Year 4	Year 5
Tax cash flow	10.80 (1)	4.80 (2)	4.80	4.80	4.80

(1) $[100 * 20\% * 30\%] + [80 * 20\% * 30\%]$

(2) $80 * 20\% * 30\%$

Discounting the group tax cash flows at a weighted average cost of capital of 20% produces a present value of R19.

If no transfer of the asset occurs, the group's tax cash flows in respect thereof can be presented in Table 2.17 as follows:

Table 2.17

Tax cash flows in respect of the asset if it is not transferred between group companies

	Year 1	Year 2	Year 3	Year 4	Year 5
Tax cash flow	6 (1)	6	6	6	6

(1) $100 * 20\% * 30\%$

Applying a discount rate of 20% to these cash flows, a present value of R18 is obtained, which is R1 less than the present value obtained in the case of a transfer of the asset.

It should be noted that the transfer of the asset from Holdco to Subco will not be advantageous in terms of the present value of tax cash flows, if the section 12C allowance was granted to Holdco at 33 1/3% per year. In such an instance, the transfer will result in deductions being granted to Subco at 20% per year, as the asset will not be new and unused after its transfer. Although a transfer in year 1 will increase the group's deductions in that year, this will be more than offset by the spreading of the remaining deductions over a period of four years instead of two years.

If the cost of an asset qualifies for deductions under section 11(e) or section 11(gA), an intra-group transfer of the asset at its tax value will not lead to an acceleration of tax relief, because section 11(e) and section 11(gA) deductions are prorated if the asset in question is only used for a portion of a year by its owner.

Although section 12B deductions are not prorated if a qualifying asset is only used for a portion of a year, a special provision states that no deduction shall be granted under that section in respect of an asset brought into use during any year of assessment if such asset was previously

brought into use by any other company during such year, and both such companies are managed, controlled or owned by substantially the same persons, and a deduction was previously granted under that section to such other company.

Section 13, which deals with deductions in respect of industrial buildings, is similar to section 12C, in the sense that deductions are not prorated and no specific anti-avoidance measure exists. However, as the annual percentage of the section 13 deduction is relatively small (alternating between 5% and 10% of cost depending on the circumstances), the increase in the present value of tax cash flows obtainable through an asset transfer will be negated by the substantial transfer costs associated with such a transfer.

2.14.2.3 Conclusion

Although various anti-avoidance provisions exist with regard to capital allowances, the intra-group transfer of certain assets still presents opportunities for the avoidance of tax by artificially inflating cost bases, or the postponement of tax by accelerating deductions. In this respect groups enjoy an unfair advantage over divisionalised companies, because the intra-divisional transfer of assets does not produce any tax effects.

2.14.3 Anomalies unfavourable to groups

In certain instances, the provisions relating to capital allowances may prejudice groups relative to divisionalised companies. An example will serve as illustration. Assume that Holdco holds an asset with a cost price of R100, a tax value of R80 (deductions having been granted in terms of section 11(e)) and a market value of R60. For some commercially justifiable reason, Holdco wants to transfer the asset to Subco. It prefers not to effect the transfer at market value as it is uncertain whether a scrapping allowance of R20 will be allowed under section 11(o). However, as Holdco and Subco are connected persons in relation to each other, the total allowances under section 11(e) to Subco may not exceed the market value of the asset at its date of acquisition by Subco. Holdco is therefore forced to effect the transfer at market value, as it is certain that the group will sacrifice allowances amounting to R20 if the transfer occurs at the asset's tax value of

R80. On the other hand, the risk exists that Holdco will not obtain an allowance under section 11(o) if the transfer occurs at the asset's market value of R60. If the asset is transferred at its market value and a scrapping allowance is not granted by the Commissioner, the group will obtain total deductions of R80 in respect of an asset which effectively cost R100. This puts the group in a disadvantageous position relative to a divisionalised company, which can transfer assets between divisions without any tax consequences.

2.15 THE STC IMPLICATIONS OF INTRA-GROUP DIVIDENDS

According to section 64B of the Act, secondary tax on companies (STC) is levied at the rate of 12,5% on the net amount of a dividend declared by a company to its shareholders. The net amount of a dividend is the amount by which such dividend declared by a company exceeds the sum of any dividends which have accrued to the company during the dividend cycle in relation to the dividend declared.

If a company declares a dividend to its holding company, STC will be paid on the entire amount thereof if it is assumed that no dividends have accrued to that company during the dividend cycle in question. When the holding company declares a dividend to the ultimate shareholders of the group, the dividend received from the subsidiary will be deducted from the dividend declared to arrive at the net amount on which STC is calculated. This means that STC will be levied only once on a dividend which is channeled through group companies before being received by the ultimate shareholders. Nevertheless, a timing disadvantage exists from the perspective of taxpayers, because STC is levied when a dividend is initially declared between group companies and not when it is declared to the ultimate shareholders.

To counter this disadvantage, section 64B(5)(f) of the Act exempts intra-group dividends from STC if certain requirements are satisfied. If a dividend is so exempted, it will not be taken into account in determining the net amount of dividends declared by the receiver thereof. This prevents profit transfers to ultimate shareholders from escaping STC altogether.

One of the requirements that must be satisfied before the exemption will apply is that only 10% of the equity capital of every group company (except the ultimate holding company) may be held by certain outside shareholders. Such outside shareholders must consist of directors and full-time employees of such a company or an associated institution in relation to such a company; or a trustee who holds the shares for the benefit of such directors and employees under a scheme referred to in section 38(2)(b) of the Companies Act.

Although the concept of groups is therefore acknowledged by the STC provisions exempting certain intra-group dividends, the required intra-group shareholdings are very demanding, and it may be necessary to ease this requirement if a system of group taxation is introduced in South Africa which provides for larger and more diverse minority shareholdings.

2.16 UNREALISED PROFITS AND LOSSES IN RESPECT OF THE INTRA-GROUP TRANSFER OF TRADING STOCK

Where trading stock is transferred between group companies at a profit and such trading stock is still held by the transferee at year end, the group will be taxed on a profit which has not been realised outside the economic entity. The transfer of trading stock between divisions of the same company will not attract any tax consequences, even if an internal profit is afforded to the transferor, with result that the tax on the intra-divisional profit is deferred until it is realised outside the company.

Where minority shareholders exist within a group structure, the intra-group transfer of trading stock at cost price will not necessarily solve the problem of tax on unrealised profits, as value will be transferred between the shareholders in the different legal entities. For example, assume that Holdco sells trading stock manufactured by it at a cost of R100 to its 75% owned subsidiary, Subco, at a price of R100. The wholesale value of such stock is R200 and its retail value is R300. At year end Subco still holds all of the above-mentioned stock and subsequent to year end all of the stock is sold to outside parties.

By transferring the trading stock at its cost to Holdco instead of the wholesale value, the group will avoid the payment of tax on an unrealised profit of R100 during the year of transfer. However, shareholders in Holdco are now only interested in 75% of the total pre-tax profit between R100 and R200, whereas they would have been interested in 100% of such profit if the stock was transferred at its wholesale value. Thus, by delaying the payment of tax on the profit until it is realised outside the group, shareholders in Holdco have sacrificed R25 of profit in favour of minority shareholders in Subco.

Where trading stock is transferred between group companies at a loss and such trading stock is still held by the transferee at year end, the group will obtain tax relief in respect of a loss which has not yet been realised outside the economic entity. However, divisionalised companies can also obtain tax relief in respect of unrealised profits on trading stock, even without transferring such stock between divisions. The reason can be found in the provisions of the Act with regard to trading stock. Section 22(1) states that the amount which shall be taken into account in the determination of a person's taxable income in respect of the value of trading stock held and not disposed of by him at the end of a year of assessment, shall be the cost price to such a person of such trading stock less an amount as the Commissioner may think just and reasonable as representing the amount by which the value of such trading stock has been diminished by reason of damage, deterioration, change of fashion, decrease in market value or any other reason satisfactory to the Commissioner.

Thus, divisionalised companies, like groups, enjoy the benefit of tax relief in respect of unrealised losses on trading stock although groups, unlike divisionalised companies, do not enjoy the benefit of deferral of tax in respect of unrealised profits on trading stock. This is clearly not an equitable tax result.

2.17 ALLOWANCES IN TERMS OF SECTIONS 24 AND 24C ON QUALIFYING INTRA-GROUP TRANSACTIONS

2.17.1 Section 24

Section 24(1) of the Act states that if any taxpayer has entered into an agreement with any other person in respect of any property the effect of which is that, in the case of movable property, the ownership shall pass, or in the case of immovable property, transfer shall be passed from the taxpayer to that other person, upon or after the receipt by the taxpayer of the whole or a certain portion of the amount payable to the taxpayer under the agreement, the whole of the amount shall be deemed to have accrued to the taxpayer on the day on which the agreement was entered into.

Agreements envisioned by section 24(1) will include hire purchase agreements, as well as sales where the customer only gets ownership against the payment of a deposit and credit is given for the balance of the purchase price (Meyerowitz, 1997: 21.3).

Section 24(2) states that in the case of any such agreement in terms of which at least 25% of the said amount payable only becomes due and payable on or after expiry of a period of not less than 12 months after the date of the said agreement, the Commissioner may make such allowance as under the special circumstances of the trade of the taxpayer seems to him reasonable, in respect of all amounts which are deemed to have accrued under such agreements but which have not been received at the close of the taxpayer's accounting period: provided that any allowance so made shall be included in the taxpayer's return for the following year of assessment and shall form part of his income.

The allowance is made at the discretion of the Commissioner and is normally calculated by multiplying the outstanding amount under a qualifying agreement by the ratio in which the gross profit stands to the turnover with regard to that agreement (Meyerowitz, 1997: 21.10). Thus the profit in respect of the agreement is effectively taxed when it is realised in cash.

The allowance granted in terms of section 24(2) creates lucrative opportunities for the deferral of taxation within a group context. Assume that Subco, a wholly owned subsidiary, acquires machinery at a cost of R300 and immediately sells it to Holdco at a retail price of R600. According to the sales agreement, ownership of the machinery will pass to Holdco when the purchase price is paid three years hence. Holdco employs the machinery directly in a process of manufacture.

If the Commissioner grants an allowance to Subco under section 24(2), the profit of R300 will only be taxed when Subco receives payment of the purchase price at the end of year three. Holdco will deduct R200 per year under section 12C in respect of its acquisition cost of R600. The connected person rule will not operate to limit Holdco's total deductions to Subco's acquisition cost, because Subco will not have received any deductions in terms of section 12C.

Table 2.18

Tax implications of section 24 agreement to Subco

	Year 1	Year 2	Year 3
Acquisition cost	(300)	-	-
Selling price	600	-	-
Section 24: Allowance	(300) (1)	(300) (1)	- (2)
Section 24: Income	-	300	300
Taxable income	-	-	300
Tax cash flows	-	-	(90) (3)

(1) $300 / 600 * 600$ (Gross profit / Selling price * Amount outstanding at year end)

(2) $300 / 600 * 0$

(3) $300 * 30\%$

Table 2.19**Tax implications of section 24 agreement to Holdco**

	Year 1	Year 2	Year 3
Section 12C	(200) (1)	(200)	(200)
Tax cash flows	60 (2)	60	60

(1) $600 * 33 \frac{1}{3}\%$

(2) $200 * 30\%$

Applying a weighted average cost of capital of 20% to the group's tax cash flows in respect of the agreement, a present value of R74 is obtained at the beginning of year one.

Had the group been a divisionalised company, section 24 would not have been applicable to the intra-divisional transaction, as it would not constitute an agreement with another person. Furthermore, the company's deductions in terms of section 12C would have been based on an acquisition cost of R300. The company would therefore have obtained an annual deduction of R100 in year 1 to year 3, translating into annual positive tax cash flows of R30 ($R100 * 30\%$). Applying a discount rate of 20% to these cash flows, a present value of R63 is obtained. The difference of R11 in favour of the group can be explained by the fact that Holdco obtained an additional section 12C deduction of R100 annually in respect of the intra-group profit of R300, while this profit was only taxed in Subco's hands at the end of year three, due to the operation of section 24(2).

It should be noted that the Commissioner may not grant a section 24 allowance where the terms of an intra-group credit agreement are not at arm's length. To return to the above example, it is unlikely that Subco will provide interest-free credit to other buyers of its machinery. However, the group may overcome this obstacle by agreeing that interest will accumulate on the outstanding amount at a market-related rate. The accrual of the interest to Subco and the incurrance thereof by Holdco will be governed by section 24J. Because the inclusion of interest in Subco's

gross income will be neutralised by the deduction thereof by Holdco, the net present value of R74 in respect of the group's tax cash flows will remain unchanged.

2.17.2 Section 24C

Section 24C(2) of the Act determines that if the income of a taxpayer in any year of assessment includes or consists of an amount received by or accrued to him in terms of any contract and the Commissioner is satisfied that such amount will be utilised in whole or in part to finance future expenditure which will be incurred by the taxpayer in the performance of obligations under the contract, there shall be deducted in the determination of the taxpayer's taxable income for such year such allowance as the Commissioner may determine, in respect of so much of such future expenditure as in his opinion relates to the said amount. Note that the Commissioner grants the allowance at his discretion. It is the policy of the Commissioner to calculate the allowance with reference to the gross profit percentage on the relevant contract (Huxham & Haupt, 1997: 358).

Section 24C(3) determines that the amount of any allowance deducted under section 24C(2) shall be deemed to be income received by or accrued to the taxpayer in the following year of assessment. Thus, in instances where income is received by or has accrued to a taxpayer before he has incurred the associated expenditure, section 24C delays the recognition of a portion of the income until the expenditure has been incurred.

Section 24C, like section 24, creates opportunities for the deferral of taxation within a group context. Assume that Holdco enters into a contract with its wholly owned subsidiary, Subco, near their year ends, whereby Subco will deliver a service to Holdco with a market value of R200 and a cost of R100. Holdco pays the amount of R200 before the year end, but Subco only delivers the service and incurs the expenditure of R100 in the following year. Assuming that the R200 paid by Holdco is not refundable, it is submitted that, for the purpose of section 11(a) of the Act, Holdco incurs the expenditure when it is paid to Subco, irrespective of the fact that the service has not been rendered yet (Huxham & Haupt, 1997: 358).

The tax implications of the above mentioned transactions are illustrated in Tables 2.20 and 2.21.

Table 2.20**Tax implications of section 24C contract to Holdco**

	Year 1	Year 2
Deduction	(200)	-
Tax cash flow	60 (1)	-

(1) $200 * 30\%$

Table 2.21**Tax implications of section 24C agreement to Subco**

	Year 1	Year 2
Gross income	200	-
Deduction of costs	-	(100)
Section 24C: allowance	(100) (1)	- (2)
Section 24C: income	-	100
Taxable income	100	-
Tax cash flows	(30) (3)	-

(1) $100 / 200 * 200 - 0$ (Total contract cost / Total contract price * Cumulative gross income to date - Cumulative cost to date)

(2) $100 / 200 * 200 - 100$

(3) $100 * 30\%$

The net tax cash flows in respect of the contract from a group perspective is an inflow of R30 at the end of year one. Had the group been a divisionalised company, the only transaction which would have attracted tax consequences would have been the incurral by Subco of the outside expenditure of R100 in year 2. The divisionalised company would therefore have obtained tax

relief of R30 at the end of year two. In the absence of section 24C, the tax result from a group perspective would have been identical to the above result, as the deduction of R200 by Holdco would have been neutralised by the inclusion in Subco's gross income of a corresponding amount. In the above-mentioned case, however, section 24C effectively transfers the deduction in respect of outside expenditure incurred by a group to the earlier year in which the intra-group transaction was concluded.

2.18 CONCLUSION

In Chapter 2 the tax effects of various intra-group transactions were examined. From this examination it is evident that the present tax treatment of groups often conflicts with the canons of taxation.

In most instances the tax effects of intra-group transactions did not cancel out from a group perspective. On the other hand, transactions between divisions of the same company do not have tax consequences. The present tax treatment of groups therefore does not achieve equity between groups and divisionalised companies.

Furthermore, neutrality may be compromised by the *status quo*. The following three reasons can be advanced as motivation. Firstly, groups may enter into certain intra-group transactions solely to obtain the benefit of favourable tax anomalies. Conversely, groups may not enter into intra-group transactions which are otherwise commercially sound because of the unfavourable tax anomalies which will result from such transactions. Finally, groups may enter into intra-group transactions which have economic merit, but may structure such transactions in a specific way to avoid unfavourable anomalies which will otherwise occur.

The present tax treatment of groups also brings about considerable administrative costs. Groups incur legal and other costs in planning and implementing intra-group transactions which aim to avoid unfavourable tax anomalies or exploit favourable tax anomalies, while the fiscus expends resources in monitoring and opposing such intra-group transactions.

It may be said that the lack of a system of group taxation prevents legislative complexity. However, because intra-group transactions are not addressed specifically in the Act, various tax issues with regard to intra-group transactions are not entirely settled. This has a negative impact on certainty. Furthermore, the fact that intra-group transactions are not exhaustively dealt with in the Act creates opportunities for tax planning, resulting in intra-group tax planning techniques which are often extremely intricate. Thus, one is presented with a situation where legislative simplicity may encourage complexity with regard to tax-driven schemes.

Efficiency of collection is a matter which has not been addressed, either directly or indirectly, in Chapter 2. The matter is discussed in Chapter 4 through a comparison of the loss transfer system of group taxation with the consolidation system. As a loss transfer system is in essence a system that combines the present tax treatment of groups with the transfer of assessed losses between group companies, such a comparison will be appropriate for evaluating the present tax treatment of groups. For present purposes it is sufficient to say that a consolidation system of group taxation will lead to an improvement in the efficiency of collection of the intended tax burden (refer to section 4.4.4 for a more detailed discussion).

It is clear that the present tax treatment of groups does not satisfy the canons of taxation discussed in Chapter 1. A question that naturally arises is whether a system of group taxation will achieve greater compliance with such canons and, if so, whether a loss transfer system or a consolidation system will achieve the greatest level of compliance. Chapter 4 is devoted to an examination of these questions. But firstly, Chapter 3 considers three diverse issues which are not directly related to the canons of taxation, but which may render a system of group taxation unnecessary or undesirable, even if such a system satisfies the theoretical requirements of an ideal system to a greater extent than the *status quo*.

3 ISSUES WITH REGARD TO THE NECESSITY AND DESIRABILITY OF A SYSTEM OF GROUP TAXATION

3.1 INTRODUCTION

The purpose of this chapter is to consider the following three issues:

- whether divisionalisation is a viable alternative to a group tax regime;
- whether it is justified to subject groups and divisionalised companies to similar tax treatment, when group companies enjoy the benefit of limited liability while divisions do not; and
- whether a group tax regime will lead to an increase in the concentration of economic control and ownership.

The first issue relates to the necessity of a system of group taxation, while the second and third issues relate to the desirability of such a system. Although a group tax regime may produce a more satisfactory trade-off between the canons of taxation, the issues identified above may render a group tax regime unnecessary or even undesirable. Examination of these issues is therefore important.

3.2 DIVISIONALISATION VERSUS A GROUP TAX REGIME

3.2.1 Introduction

Opponents of a group tax regime may argue that anomalies arising from the current tax treatment of groups can be avoided by structuring new enterprises as divisions of existing companies. Similarly they may argue that existing enterprises located within separate group companies can be divisionalised, particularly as section 39 of the Taxation Laws Amendment Act (1994) addresses the tax obstacles associated with such restructurings (Crisp, n.d.: 1).

It will be demonstrated below that section 39 of the said Act is not a very accessible mechanism to facilitate the divisionalisation of existing group structures. In addition, there are various commercial and legal reasons why groups may be preferred over divisionalised companies.

3.2.2 Section 39 of the Taxation Laws Amendment Act, No. 20 of 1994

3.2.2.1 Operation

Section 39 of the Taxation Laws Amendment Act (1994) provides for the exemption of stamp duty and transfer duty with regard to rationalisation schemes for groups of companies, and governs the income tax treatment pertaining to such schemes. It contains the following tax-friendly measures:

- the registration of transfer to a transferee company of marketable securities, the cession of bonds and the substitution of debtors shall be exempt from stamp duty;
- the acquisition of property by a transferee company will be exempt from transfer duty;
- any trading stock disposed of may be deemed to have been sold by the transferor company to the transferee company at a price equal to the value of such trading stock in the hands of the transferor company as determined under the provisions of section 22(1) of the Income Tax Act, and shall be deemed to have been acquired by the transferee company as trading stock;
- any building, machine, plant, implement, utensil or article so disposed of, the value of which is to be taken into account for purposes of the Income Tax Act, shall in so far as the transferor company is concerned, be deemed to have been sold by it at a price equal to the tax value in its hands;
- the transferor company and the transferee company shall, subject to such provisions as may be necessary, be deemed to be one and the same company; and
- where any sale, disposal, transfer, cession or substitution of any asset give rise to the distribution of a dividend, such distribution shall be exempted from Secondary Tax on Companies.

Section 39 therefore creates a tax neutral environment in which to effect rationalisation schemes, including the divisionalisation of group structures. Interestingly, many of the measures of this section will also be encountered in consolidation systems of group taxation. However, paragraph 6(c)(ii) of section 39 may act as a disincentive to divisionalisation, by stating that a transferee company shall not be permitted to set off an assessed loss incurred by the transferor company. Thus where a group company with an assessed loss is to be incorporated as a division of another group- company, its assessed loss will be permanently sacrificed.

3.2.2.2 Scope

Section 39 is only applicable where a group of companies engages in a rationalisation scheme. Paragraph 1 of that section defines 'group of companies' and 'rationalisation scheme'.

A 'group of companies' means a controlling company and one or more other companies which are controlled companies in relation to the controlling company. A 'controlled company' is defined as a company in relation to which another company is the controlling company. A 'controlling company', in relation to another company, means a listed company that holds for its own benefit, whether directly or indirectly through one or more companies in the group of companies of which all the companies in question are members, shares in such other company which, together with shares in that company held by a trustee under a scheme referred to in section 38(2)(b) of the Companies Act, constitutes no less than 75% of the equity share capital of the said company.

The required shareholding level set by the definition cannot be faulted, as a holding of 75% implies a sufficiently close association between separate entities to warrant the easing of their rationalisation from a tax perspective. However, by restricting the definition of controlling companies to listed entities, the scope of section 39 is severely limited. This restriction was included to reduce the potential administrative burden of such legislation on the Receiver of Revenue (Crisp, n.d.: 3). As a result, many unlisted groups will not be able to utilise the provisions of section 39 to achieve a tax-friendly rationalisation. It can therefore be said that

section 39 is not a very accessible tool for the transformation of existing groups into divisionalised companies.

A 'rationalisation scheme' is defined as any scheme for the rationalisation of the activities of group companies where –

- such scheme was devised solely or mainly (I) in order to achieve substantial and enduring savings in operational expenditure or substantial and enduring operational and administrative advantages within the said group; or (II) in the furtherance of and for the purpose of benefiting some or all of the activities of the said group which before the transfer thereof were carried out by one or more companies of the said group and after the transfer thereof will be carried out by one or more other companies of the said group; or
- the Commissioner is, having regard to the circumstances of the case and subject to such conditions as he may impose, satisfied that such scheme was devised solely or mainly to effect an unbundling transaction as contemplated in section 60 of the Income Tax Act of 1993. (For the purpose of this work, unbundling transactions are not relevant. They represent the exact opposite of grouping, by distributing shares previously held by holding companies to ultimate shareholders.)

Section 39(7) determines that the provisions of the section shall not apply if the main or one of the main purposes of the rationalisation scheme is the avoidance, postponement or reduction of liability for the payment of any tax, duty or levy which, but for the provisions of section 39, would have been payable in consequence of such a scheme having been entered into.

From the definition of rationalisation schemes and the provisions of paragraph 7, it is abundantly clear that the tax concessions of section 39 will only be granted if the scheme has a commercial purpose other than the achievement of a more favourable tax dispensation. As such, section 39 is therefore a poor alternative to a group tax regime that specifically aims to subject groups to a more equitable and reasonable tax treatment.

3.2.2.3 Conclusion

Section 39 contains various measures intended to create a tax environment conducive to divisionalisation. However, the permanent sacrificing of assessed losses will serve to discourage, rather than encourage, the divisionalisation of group structures. Furthermore, by restricting its application firstly to groups with listed holding companies, and secondly to schemes where a tax motive is not predominant, section 39 is not an accessible mechanism for the avoidance of tax anomalies brought about by the present tax treatment of group structures.

3.2.3 Reasons for groups instead of divisionalised companies

Although section 39 of the Tax Laws Amendment Act, (1994) may ease the divisionalisation of existing group structures in very specific circumstances, various commercial and legal reasons may exist to inhibit such divisionalisation, including the following:

- Valuable licenses and rights may be specifically linked to individual group companies (Suid-Afrika, 1987: 206).
- In certain regulated industries it is required that companies be kept separate, such as in the pharmaceutical industry (Suid-Afrika, 1987: 206).
- Various forms of loan covenants and agreements with bankers may prohibit the transfer of assets (Suid-Afrika, 1987: 206).
- The group may not wish to disturb trade union agreements by merging or selling assets (Suid-Afrika, 1987: 206).
- There may be contracts in existence with executives in the employment of individual group companies (Suid-Afrika, 1987: 206).
- The corporate identity of individual group companies may have substantial brand value (Aginsky, 1984: 9).

Other commercial and legal considerations exist which not only inhibit the divisionalisation of existing group structures, but also encourage the formation of separate group companies for new enterprises. These considerations are as follows:

(i) Director status

Director status can be conferred on managers responsible for certain activities by locating such activities in separate companies. Demands for director status are increasingly being made by managers seeking job recognition, and by acknowledging these demands the motivation of managers will be improved (Aginsky, 1984: 9).

On the other hand, divisionalisation of subsidiaries will cause the directors of such subsidiaries to lose their status as directors. This will be detrimental to staff relations and motivation. A possible solution in such instances may be the creation of divisional director posts. However, this may be perceived by staff as an artificial and therefore unsatisfactory compromise (Aginsky, 1984: 20).

(ii) Separation of business operations

When the sale of an enterprise is being negotiated, its assets, liabilities and profit potential is normally more easily identifiable if the enterprise is located within a separate company instead of a separate division (Aginsky, 1984: 20). Thus, by placing an enterprise within an independent legal entity, its marketability to other investors is improved. This provides the initiator of a new enterprise with an alternative course of action in respect thereof; instead of merely operating it indefinitely for profit, he can also dispose of it with relative ease and thereby realise a capital gain. The utilisation of separate companies may therefore encourage economic activity by providing entrepreneurs with more convenient exit options.

The maintenance of a separate company for each business operation also facilitates the independent listing thereof on a stock exchange, thereby further enhancing its marketability to prospective investors. In addition, a listing may also increase the profile of the enterprise, and motivate its management and employees. The latter benefit is achieved in two ways: firstly, the prospect of intense public scrutiny may extract greater performance from management and, secondly, the increased marketability of the enterprise's shares enables the implementation of share incentive schemes.

Finally, by segregating enterprises using separate companies, the appropriate cost of finance for each enterprise may be easier to determine, as risks pertaining to enterprise-specific cash flows can be assessed more accurately. In the case of divisionalised companies, it may happen that composite risk levels are assigned to aggregate cash flows. This may lead to a situation where a particular project is not accepted, because its estimated rate of return is lower than the composite rate of return required for the divisionalised company, although the estimated rate of return is equal to or higher than the rate of return required for the particular venture. Conversely, a project may be accepted because its estimated rate of return is higher than the composite rate of return required for the divisionalised entity, although the estimated rate of return is lower than the return required for the particular project.

(iii) Regional emphasis

With an increased regional emphasis in South Africa, it may be preferable for an enterprise restricted to a specific geographical area to be structured as a separate subsidiary instead of a division of a company domiciled in another region (Suid-Afrika, 1987: 206). By directing attention to the separate identity of the regional company, local goodwill towards that enterprise may be increased.

(iv) Less disruptive enforced dissolution

Enforced dissolution, such as in a monopoly situation, will be achieved with less disruption if the enterprise in question is located within a separate company. Because the activities, assets and liabilities of that enterprise will already be segregated, the dissolution can be effected by merely disposing of the shares in the subsidiary. (Aginsky, 1984: 11) In the case of a divisionalised structure, it may be necessary to entangle a complex interlocking of activities, assets and liabilities in respect of the various divisions.

(v) Increased autonomy leading to improved management performance

If the enterprises for which managers are responsible are located within separate companies, their motivation might be increased due to the perception of increased autonomy (Cronje, n.d.(a): 3). Furthermore, the concept of profit or investment centres may be emphasised if business ventures are separated by legal boundaries. In contrast, a divisionalised structure may lull managers into complacency if the perception exists that non-performing divisions will be supported by stronger divisions within the company.

3.3 THE ISSUE OF LIMITED LIABILITY

Opponents of a group tax regime may argue that groups should not be entitled to the tax advantages of divisionalised companies, as individual companies within a group enjoy the benefit of limited liability, while divisions within a company do not enjoy this benefit (Suid-Afrika, 1987: 208). The sentiment that companies should accept the disadvantages of their separate identity along with their advantages is echoed in court judgements. In *Ochberg v CIR* (1931), a case which dealt with the capital or revenue nature of capitalisation shares received by the sole shareholder of that company for services rendered, De Villiers, C.J. said the following: "I entirely agree with the view that the Court may look at the substance of the transaction. But that argument must be employed with judgement, more especially in company law. The law endows a company with a fictitious personality. The wisdom of allowing a person to avoid the natural consequences of his commercial sins under the ordinary law, and for his own private purposes virtually to turn himself into a corporation with limited liability, may well be open to doubt. But as long as the law allows it, the Court has to recognize the position. But then too the person himself must abide by that. A company, being a juristic person, remains a juristic person separate and distinct from the person who may own all the shares, and must not be confused with the latter. To say that a company sustains a separate persona and yet in the same breath to argue that in substance the person holding all the shares is the company, is an attempt to have it both ways, which cannot be allowed." Although the above *Ochberg* case considered the relationship between a company and its sole shareholder, rather than the relationship between companies within the same group, the principle enunciated therein is nevertheless relevant in the context of groups. In

fact, the dictum quoted above was referred to in ITC 629 (1933), a case which dealt with the setting off by a holding company of its wholly owned subsidiary's assessed loss.

Several arguments can be advanced in opposition to the view that a company should endure the tax disadvantages of its separate identity along with the advantage of limited liability.

Firstly, the concept of limited liability is a valuable tool for encouraging the formation of new enterprises, especially where such enterprises carry a significant level of risk. However, in the absence of a group tax regime, the location of new enterprises in separate companies may result in the accumulation of assessed losses within such companies that cannot be set off against other group income. Plans for new enterprises may be therefore be abandoned, as immediate tax relief for initial losses cannot be obtained without exposing existing operations to an increased level of risk. Thus, a system of group taxation will be a complementary measure to limited liability, which will increase its effectiveness in promoting economic growth.

Secondly, limited liability is often incorrectly perceived as an instrument open to abuse. In practice, the limited liability of separate companies within a group is rarely exploited. Creditors often require guarantees from or claims on the assets of holding companies when transacting with subsidiaries. And even when this is not the case, a holding company will often assume responsibility for the unmet liabilities of a troubled subsidiary in fear that the group's image will otherwise be tarnished (Aginsky, 1984: 10). In practice, therefore, the concept of limited liability is extended in practice to groups instead of being restricted to individual group companies. This brings about a similar situation to that of single, divisionalised companies where the companies and not their individual divisions enjoy the benefit of limited liability.

Finally, if the implementation of a group regime will represent a significant structural improvement to the tax system, the issue of limited liability should not stand in the way of its implementation. If it is deemed necessary, additional legislation can be introduced by means of the Companies Act to specifically address the issue of limited liability within group context (Du Toit & Matthews, 1990: 22).

3.4 CONCENTRATION OF ECONOMIC CONTROL AND OWNERSHIP

Another reason advanced against group taxation is that it will encourage conglomeration. The issue of conglomeration has become highly politicised in South Africa and thus cannot be ignored in the context of a submission regarding group taxation. Bearing in mind the political storm that surrounds conglomeration, the concept seems to turn on the matter of economic control (Du Toit & Matthews, 1990: 23). In this regard the degree of association required for control is often confused with the degree of association required for group tax treatment. Control is usually exercised through little more than a 50% holding, and in many other instances through a much smaller holding. In contrast, most group tax regimes require a much higher degree of association before group tax treatment is applied. For example, the system employed in the United States of America requires an 80% holding, while the United Kingdom system requires a 75% holding. Therefore, when investors seek to increase their holding beyond the maximum 50% plus one share that is usually necessary for control, they do so for reasons that have nothing to do with control (Du Toit & Matthews, 1990: 25).

A more valid argument would be that the introduction of a group tax regime will lead to the expelling of minority shareholders from group structures as groups seek to increase their inter-company shareholdings in order to qualify for group tax treatment. A group tax regime may therefore encourage the concentration of economic ownership, rather than the concentration of economic control. However, several convincing counter-arguments can be advanced.

Firstly, minority shareholders can be accommodated within a group tax regime by specifying required shareholder interests of less than 100%. In Chapter 1 a minimum shareholder interest of 75% was recommended, which will allow minority shareholders to participate in individual group companies to the maximum extent of 25% holdings.

Secondly, groups may reduce their holdings in certain group companies in order to release funds which can be utilised to increase holdings in other group companies to the level required for group tax treatment (Du Toit & Matthews, 1990: 25). Although the concentration of economic ownership in certain companies will increase, there will be a commensurate decrease in the

concentration of economic ownership in other companies. It is even possible that this process will reduce the concentration of economic control if shareholdings in certain companies are sufficiently reduced.

Thirdly, under the present tax regime the only way in which an existing group can achieve a tax result similar to the result that would have been achieved under a group tax system, is to restructure the group into a divisionalised company. This requires that shareholdings in subsidiaries that are not wholly owned must be increased to 100% before such subsidiaries can be transformed into divisions of the holding company. In the process minority shareholders will inevitably be expelled from group companies (Cronje, 1995: 3). This can be avoided if a group tax regime is implemented which requires intra-group holdings of less than 100%. Furthermore, a group tax regime will encourage the formation of separate companies for new enterprises, and may cause existing divisionalised companies to restructure into groups to take advantage of the commercial advantages of group structures. In both instances minority shareholders can be introduced into such companies, enabling them to obtain direct interests in the enterprises in question.

Finally, the implementation of a group tax regime will add impetus to the restructuring of various government-owned enterprises, which might bring sub-units of such enterprises to smaller emerging investors. Presently, such restructuring is inhibited by the absence of a group tax regime, because state and semi-state enterprises that organise themselves into multi-company structures will not be able to extend their typically large assessed losses to profitable pockets that have been spinned off (South Africa, 1995: 97).

In summary, it can be said that a system of group taxation will not encourage the concentration of economic control. Although it may cause an increase in the concentration of economic ownership of certain group companies, this will probably be accompanied by a decrease in the concentration of economic ownership of other group companies. Furthermore, a group taxation system will enable minority shareholdings in subsidiaries that would otherwise be structured as divisions.

4 A GROUP TAX REGIME AND THE CANONS OF TAXATION

4.1 INTRODUCTION

In Chapter 2, it was concluded that the current tax treatment of groups is far from satisfactory when considered against the background of the canons of taxation. In this chapter the consolidation system and loss transfer system of group taxation will be measured against these canons to determine whether the implementation of one of the systems will represent a structural improvement to the South African tax regime.

4.2 OPERATION OF LOSS TRANSFER SYSTEMS AND CONSOLIDATION SYSTEMS OF GROUP TAXATION

When a system of group taxation is designed for a particular tax jurisdiction, it is adapted to the unique structure of that jurisdiction's tax legislation and to the specific policy considerations which are prevalent in that jurisdiction. Consequently, no two systems of group taxation encountered in practice are identical. In the same light, although important lessons with regard to detailed design may be learnt from studying foreign jurisdictions' group tax systems, it will be wholly inappropriate to clone a foreign system for South African use. This section will therefore not examine group tax regimes in other countries. Instead, it will briefly explore the general characteristics of loss transfer and consolidation systems. Such an exploration is necessary before the two systems' compliance with the various canons of taxation can be evaluated.

Loss transfer systems treat individual group companies as separate taxable entities. Consequently, transactions between such group companies do have tax effects. In this regard loss transfer systems are very similar to the present tax treatment of groups in South Africa. In a loss transfer system the group is only acknowledged to the extent that assessed losses of certain group members may be set off against the income of other group members.

Consolidation systems treat the group, instead of the individual group companies, as the taxable entity. Transactions between group companies are subjected to special rules so that they will have

no tax effects. The tax result will therefore be very similar to the result that would have been achieved if the group had been a divisionalised company. Because the taxable incomes of individual group companies are consolidated, loss transfers between group companies occur automatically.

In the remainder of Chapter 4 loss transfer systems and consolidation systems will be compared under the headings of the various canons of taxation. Because loss transfer systems are so similar to the present tax treatment of groups (except that loss transfer systems allow the utilisation of assessed losses on a group-wide level), the current tax regime pertaining to groups will implicitly be included in the comparison.

4.3 EQUITY AND NEUTRALITY

With regard to equity as well as neutrality, a consolidation system is more satisfactory than both a loss transfer system and the present tax treatment of groups. A loss transfer system achieves greater equity between groups and divisionalised companies in only one respect - by allowing the transfer of losses between different legal entities within the same economic entity. However, in a loss transfer system transactions between group companies still have tax effects, which may lead to favourable or unfavourable tax results relative to the tax results of divisionalised companies. Chapter 2 illustrated several anomalies that may occur in this regard. A consolidation system, on the other hand, achieves a greater level of equity between groups and divisionalised companies by eliminating the tax effects of intra-group transactions.

Because a consolidation system achieves greater equity than a loss transfer system, it promotes neutrality more effectively. As the tax results of a group under a consolidation regime will be virtually identical to the tax results of a divisionalised company, the economic activities of a group will not be influenced by its tax position relative to the hypothetical tax position that would have existed if the group had been a divisionalised company. A loss transfer system, by attributing tax effects to intra-group transactions, will still encourage transactions that are specifically aimed at the exploitation of favourable tax anomalies. Furthermore, it will discourage otherwise commercially sound transactions due to its potential for unfavourable tax anomalies.

It is an undisputed fact accepted by all interest groups in South Africa that economic growth is essential in addressing the economic imbalances existing in our country. Tax-induced economic activity results in a misallocation of resources and therefore has a detrimental effect on economic growth. By achieving a higher level of equity and neutrality than both a loss transfer system and the *status quo*, a consolidation system will deliver the greatest contribution to improving South Africa's precarious socio-economic situation.

4.4 REVENUE NEUTRALITY, INCLUDING EFFICIENCY OF COLLECTION OF THE INTENDED TAX BURDEN

4.4.1 Introduction

The South African government has committed itself to fiscal discipline as part of a macro-economic policy aimed at sustained long-term growth. Nevertheless, it faces enormous demands from its main constituency for the redistribution of resources to address the inequalities created by South Africa's past dispensation. The conflicting pressures of fiscal discipline and increased welfare expenditure imply that tax reforms leading to a material reduction in the amount of tax revenue, will simply not be acceptable. If a system of group taxation is implemented in South Africa, it should therefore be revenue neutral at the least.

The total amount of revenue collected by the fiscus is a function of three factors, namely the tax base of the jurisdiction, the tax burden intended by the system of taxation and the efficiency of collection of the intended tax burden. When the impact of a group tax regime on the amount of tax revenue is evaluated, it is therefore important to consider its effect on all three factors. The third factor, namely the efficiency of collection of the intended tax burden, is one of the canons of taxation discussed in Chapter 1. It will be addressed below as one of the sub-components of revenue neutrality.

4.4.2 Tax base

In section 4.3 it was stated that a consolidation system would achieve a greater level of neutrality than a loss transfer system or the *status quo*. By not interfering with economic processes, a consolidation system will make the biggest contribution to economic growth, which in turn will lead to an increase in the tax base.

4.4.3 The intended tax burden

4.4.3.1 Introduction

Factors to be considered when evaluating the impact of a group tax regime on the intended tax burden include:

- the accelerated utilisation of current assessed losses;
- the accelerated utilisation of historical assessed losses; and
- the tax effects of intra-group transactions.

4.4.3.2 Current assessed losses

Regardless of which system of group taxation is employed, the utilisation of current assessed losses will be accelerated. In the absence of a group tax regime, a group company with an assessed loss can only set it off against its own future income. Thus the tax relief obtainable from the assessed loss will be delayed. Within a group tax regime an assessed loss of one group company will be set off against the income of another group company when it is incurred, thus providing immediate tax relief. A group tax regime will therefore not reduce the ultimate amount of revenue collected by the fiscus. Nevertheless, the fiscus will suffer a timing disadvantage in respect of revenue inflows, due to the accelerated utilisation of assessed losses within groups.

However, it is questionable whether the present tax treatment of groups leads to significant delays in the claiming of tax relief concerning current assessed losses of individual group

companies. Many groups that had a potential for material profit/loss discrepancies between individual group companies will have utilised section 39 of the Tax Laws Amendment Act, (1994) to divisionalise their operations. And where such groups do not qualify for the relief provided by that section, or where they prefer not to divisionalise due to commercial or legal considerations, income transfer techniques are no doubt employed to achieve immediate utilisation of current assessed losses. Many of these techniques may be subject to an attack under section 103(2), but it is unlikely that more than a small percentage of potentially vulnerable situations are successfully pursued by the tax authorities.

It must be remembered that section 103(2) contains a very useful escape clause for taxpayers, namely that the sole or main purpose of the agreement or change in shareholding must be to avoid, reduce or postpone the liability for tax. The flexibility created by the special relationships which exist between group companies makes it relatively easy to structure transactions aimed at the transferring of income in such a way that it appears to have a commercial purpose other than the avoidance, postponement or reduction of a liability for tax. And even if section 103(2) is theoretically applicable to certain arrangements whereby income is transferred between group members, the majority of such arrangements will not easily come to the notice of the tax authorities, by virtue of the fact that losses which would have attracted possible attention do not come about in the first place (Du Toit and Matthews, 1990: 12).

In certain instances the implementation of a group tax regime may lead to an actual reduction in the amount of revenue collected by the fiscus, instead of a mere delay in the collection thereof. This is due to the fact that a company cannot automatically carry forward an assessed loss to the next year of assessment - section 20 of the Act contains certain implicit requirements which must be satisfied before such a carry forward can occur. Section 20(1)(a) states that "for the purposes of determining the taxable income derived by any person from carrying on any trade within the Republic, there shall be set off against the income so derived by such a person any balance of assessed loss incurred by the taxpayer in any previous year of assessment which has been carried forward from the preceding year of assessment."

According to the judgement in *New Urban Properties Ltd v CIR* (1966), the wording of section 20(1)(a) envisages a continuity in setting off an assessed loss in each succeeding year in which it was originally incurred, so that in each succeeding year a balance can be struck which can be carried forward from year to year until it is exhausted. If this continuity is for any reason interrupted in any year (for example, because no trade is carried on in that year) so that the assessed loss cannot be set off and balanced in that year, then there can be no balance of assessed loss to be carried forward to the next year (Meyerowitz, 1997: 12-67). Thus, if a taxpayer has an assessed loss in year one but does not trade in year two, no balance of assessed loss will be struck in year two, which can be carried forward for set off against income of year three and succeeding years of assessment. In this instance the tax relief embodied by the assessed loss will be sacrificed permanently. If a group tax regime is implemented, the immediate utilisation of certain companies' assessed losses against other group income will prevent such losses from being subjected to the requirements for carry forwards contained in section 20(1)(a). This may lead to a reduction in the amount of assessed losses that will be sterilised.

The mere fact that a company keeps itself alive during a year of assessment without trading is not enough for the carry forward of its assessed loss into the succeeding year (*SA Bazaars (Pty) Ltd v CIR*, 1952). However, this principle is not particularly protective of revenue collection, as it is easy in practice to satisfy the trade requirement set by section 20. For example, in *ITC 777* (1953) it was held that an unsuccessful endeavour to let fixed property constituted the carrying on of a trade. It was stated in that case that the extent of the effort or the amount of money expended cannot be the test whether a company is trying to get business, and that it is sufficient if there is merely an attempt to obtain business, even if no money is expended. A group company can therefore preserve an assessed loss for prolonged periods with relative ease, until an opportunity arises for the earning of income against which the loss can be set off. Unless such a company is wound up with an unutilised assessed loss (which is unlikely in the event of astute group tax planning), it cannot be said that the implementation of a group tax system will materially reduce the ultimate amount of revenue collected.

4.4.3.3 Historical assessed losses

If a group tax system allows historical assessed losses that have accumulated until the date of its implementation to be utilised against the income of other companies in the group, the overall cost to the fiscus may be prohibitive. It should be noted that the potential tax relief inherent in accumulated assessed losses in effect represents float in the hands of the fiscus. This may be illustrated by the following example. Company A earns taxable income of R100 in year 1 on which it pays tax of R35. In year 2 the company sustains an assessed loss of R100, which it may carry forward to the succeeding year of assessment. Company A's cumulative taxable income at the end of year 2 is zero, and yet it has paid tax of R35. This constitutes a prepayment of tax by the company, which will only be fully reversed once it earns further taxable income in excess of R100. A group tax regime that allows the intra-group set off of assessed losses which have accumulated until its implementation, will cause a massive acceleration of the reversal of the fiscus's float. Such accelerated repayment of the float simply cannot be afforded by the fiscus at this stage.

Most of the foreign jurisdictions that implemented group tax systems have encountered a similar problem and have devised measures to address it. For example, it can be determined that assessed losses existing within qualifying groups prior to the implementation of the group tax system may not be set off against any income other than that of the originating company (Du Toit and Matthews, 1990: 13). Alternatively, it can be determined that such assessed losses shall be closed off while group tax treatment applies to a particular group. If a company exits the group, the closed off assessed loss attributable to that company may once again be available for set off against its income. Similar measures may also be applied to the assessed losses of companies forming or entering a group after the implementation date of the group tax regime.

4.4.3.4 The tax effects of intra-group transactions

The distinction between consolidation systems and loss transfer systems is not important when the issues of historical and current assessed losses are considered, as both systems potentially

allow the transfer of such losses between group members. The distinction between the two types of systems becomes important, however, when the matter of intra-group transactions is considered.

A consolidation system, by disregarding intra-group transactions for tax purposes, eliminates one of the fundamental instruments of group tax avoidance, namely the utilisation of separate legal entities within one economic entity to achieve favourable tax results that would not have been possible in a divisionalised company. Tax avoidance techniques that will be countered by a consolidation system include the following:

Techniques that reduce the ultimate amount of revenue collected by the fiscus

- Capital/revenue mismatches that result in one group member obtaining a deduction for its expenditure under section 11(a), while the corresponding receipt/accrual is not included in the gross income of the another group member (refer to section 2.2.5).
- Losses on intra-group loans, where the loss is deductible by the lender and tax relief was obtained by the borrower in respect of the expenditure financed by the proceeds of the loan (refer to section 2.6.2).
- The transfer of an asset, previously held as capital, to a separate trading company, so that the gain on disposal to an outside party can be split into a capital and revenue portion (refer to section 2.7.3).
- Intra-group leases that obligate the lessee to effect improvements to the property of the lessor, where the lessee spends significantly more than is required of him and obtains a deduction of the excess under section 11(t), section 13 or section 13ter, while the lessor only includes in his gross income the amount stipulated in the agreement or the reasonable value of the improvements that the lessee was obligated to effect (refer to section 2.10).
- The intra-group transfer of section 24J instruments in the following two instances. Firstly, the issuer of an instrument may transfer it to another group member, paying compensation below the initial amount. The gain below the

initial amount will be of a capital nature and therefore not taxable if the issuer is not a trader in such instruments. However, this gain will form a portion of the deductible interest expenditure of the other group company. Secondly, the holder of an instrument may transfer it to another group member at a price in excess of the adjusted initial amount. In this instance the gain made by the original holder may be of a capital nature and therefore not taxable, thereby replacing an amount of otherwise taxable interest (refer to section 2.11.2).

- The intra-group transfer of fixed assets between group members to artificially inflate their cost bases in instances where the connected person rules do not apply (refer to section 2.14.2.1).

Techniques that provide taxpayers with timing advantages

- The intra-group transfer of fixed assets to accelerate allowances in respect thereof (refer to section 2.14.2.2).
- The deferral of taxation by executing an intra-group transaction where the group company to which an amount accrues is granted an allowance in terms of section 24 or 24C which will only be added to its taxable income in a following year of assessment, while the group company that incurs the amount as expenditure immediately obtains a deduction (refer to section 2.17).

If it is assumed that section 103(1) is not applicable to the above-mentioned techniques, they will relate to the intended tax burden and not to the efficiency of collection of that burden. On the other hand, if it is assumed that section 103(1) is applicable to the above-mentioned techniques, but that it is not invoked due to oversight by the tax authorities, the techniques will relate to the efficiency of collection of the intended tax burden. In such an instance the discussion in section 4.4.4 will be relevant.

The present tax treatment of groups also gives rise to various tax anomalies which have a positive effect on the intended tax burden. These anomalies will remain if a loss transfer system is

implemented, as it treats the individual group companies as separate taxable entities. Some of the anomalies are as follows:

Anomalies that increase the ultimate amount of revenue collected by the fiscus

- General income/expenditure transactions, where the amount received by or accrued to one group member is included in its gross income, while the amount incurred by the other group member is not deductible because the production of income requirement of section 11(a) and the trade requirement of section 23(g) are not satisfied (refer to section 2.2.4).
- Capital/revenue mismatches, where the amount received by or accrued to one group company is included in its gross income, while the other group company cannot obtain a deduction for the expenditure incurred by it (refer to section 2.2.5).
- Costs incurred in respect of the provision of intra-group services, where the tax effects of the income and corresponding expenditure of the different group members neutralise each other, but where the group member receiving the income is not granted a deduction of its expenditure because the production of income requirement of section 11(a) and the trade requirement of section 23(g) are not satisfied (refer to section 2.3).
- Transactions with unrelated parties whereby one group member incurs expenditure for the benefit of another group member, and a deduction is not granted to it because the production of income requirement of section 11(a) and the trade requirement of section 23(g) are not satisfied in relation to the group member incurring the expenditure (refer to section 2.4).
- Interest on loans used to purchase shares in other group members, where such interest is not deductible because it is not incurred in the production of income as defined, although the shares are merely a legal interface between the acquiring company and a business that is to be actively managed by it (refer to section 2.5).
- Losses on intra-group loans, where the loss is not deductible by the lender because it is considered to be of a capital nature, while no tax relief has been or will be obtained

by the defaulting borrower in respect of the expenditure financed by the loan (refer to section 2.6.2).

- The acquisition of a capital asset by one group member from another and its subsequent realisation, where the proceeds of the realisation are considered as revenue in the hands of the realising company due to a history of trading in similar assets, while the disposal of the asset in group context is merely the realisation of a capital asset to the best advantage of the group (refer to section 2.7.2.2).
- Intra-group leases where the lessee is obligated to effect improvements to the property of the lessor, and the lessee spends less than is required of him. In such an instance the lessee will obtain deductions on the actual cost of the improvements, while the lessor must nevertheless include in his gross income the amount stipulated in the agreement or the reasonable value of the specified improvements (refer to section 2.10).
- The intra-group transfer of section 24J instruments in the following two instances. Firstly, the issuer of an instrument may transfer it, paying an amount in excess of the adjusted initial amount. If he is not a trader in instruments, the resultant loss will be of a capital nature and therefore not deductible. The capital loss will be excluded from the determination of the amount of deductible expenditure incurred by the other group member. Secondly, the holder of an instrument may transfer it at a price below the initial amount. Again, if the holder is not a trader in such instruments, the loss below the initial amount will be of a capital nature and therefore not deductible under section 11(a). However, such capital loss will effectively be included in the determination of the taxable amount of interest accrued to the other group company (refer to section 2.11.2).
- The intra-group transfer of fixed assets in cases where there is interaction between the connected person rules and section 11(o). If the market value of the asset so transferred is below its tax value, and a scrapping allowance is not allowed to the transferor, the group will not obtain a deduction of that portion of the cost of the asset representing the difference between its tax and market value on the date of transfer (refer to section 2.14.3).

Anomalies that cause taxpayers to suffer timing disadvantages

- Conditional intra-group payments where the amount is received by one group member and therefore included in its gross income, although the corresponding expenditure has not yet been incurred by the other group member and consequently is not deductible (refer to section 2.2.3).
- Intra-group lease premiums where the lessee's deductions in respect of the premium is spread over a number of years, while the lessor must include the entire amount of the premium in his gross income once it has accrued to or has been received by him (refer to section 2.9).
- Intra-group leasehold improvements where the lessee's deductions in respect of the cost of the improvements will be spread over a number of years, while the lessor must include the entire amount thereof once the improvements are completed (refer to section 2.10).
- The taxation of profits arising from intra-group trading stock transfers where such profits have not yet been realised outside the group (refer to section 2.16).

Because a consolidation system will eliminate anomalies both favourable to taxpayers and favourable to the fiscus, the question arises whether it will produce a net increase or net decrease in the intended tax burden. In this regard it must be remembered that group structures are generally employed for sizable and complex enterprises and that the economic power of such enterprises affords a high level of sophistication in matters such as tax planning. It is therefore likely that groups will structure their activities in such a way that the anomalies producing unfavourable tax effects are avoided, while the anomalies producing favourable tax effects are fully exploited. The implementation of a consolidation system will therefore probably result in a net increase in the intended tax burden concerning intra-group transactions, whereas the implementation of a loss transfer system will merely maintain the *status quo*.

4.4.4 Efficiency of collection of the intended tax burden

Du Toit and Matthews (1990: 18) are of the opinion that a consolidation system will be more efficient from an administrative perspective than both a loss transfer system and the present tax treatment of groups. This derives from three factors in particular:

- A consolidation system involves fewer corporate tax returns than a loss transfer system. In the former system a group renders a single consolidated return that needs to be assessed, whereas in the latter system individual group companies continue to be assessed as separate taxable entities. Every return that must be assessed involves a certain fixed quantity of administration. The implementation of a consolidated system will avoid unnecessary duplication of such administration within a group, thereby achieving greater economies of scale.
- A consolidation system regards intra-group transactions as tax irrelevant and therefore reduces the number of transactions requiring administration and policing. A loss transfer system, on the other hand, treats intra-group transactions as tax relevant. This causes the mirroring tax effects of taxability and deductibility, which does not influence the total amount of revenue due. Nevertheless, intra-group transactions must be administered and policed - once they are tax relevant they may become the object of intra-group manipulation towards changing an overall neutral tax result into a result that is beneficial to the group.
- A consolidation system of group tax not only reduces the number of transactions that are tax relevant, but also aligns tax relevance with economic relevance. In a consolidation system the only relevant transactions for tax purposes are those concluded with outside parties. Transactions between entities that are owned by the same economic interests can be manipulated for tax reasons without affecting the overall wealth of those interests. On the other hand, transactions concluded between conflicting economic interests will have a real impact on wealth and therefore are much less likely to be employed for tax manipulation. Thus transactions executed across the borders of independent economic interests are self-policing to a certain extent, thereby assisting the tax authorities in their monitoring task.

The fact that group tax systems usually function on an election basis may further contribute to improved efficiency in the case of a consolidated regime. Groups that have more to lose from the exploitation of favourable anomalies arising from intra-group transactions than they have to gain from the accelerated utilisation of assessed losses, will not elect group tax treatment. This may alert the tax authorities to previously undetected group schemes that can be attacked successfully under specific or general anti-avoidance provisions (Dieperink, 1995: 1). Such a warning feature will not be available in the case of a loss transfer system, because intra-group transactions will still have tax effects. Non-election by group companies during a year of assessment will simply indicate that there are no assessed losses to transfer during that particular year.

A further advantage of a consolidation system over a loss transfer system relating to efficiency of collection is that it will more effectively direct the attention of the tax authorities to avoidance schemes which involve parties unrelated to the group. In section 2.13.2.2, it was stated that the non-deductible acquisition cost of a capital asset can be converted into a deductible lease premium, if the asset is acquired by a trading company within the group and the usufruct and bare dominium are subsequently transferred to other group companies. Assume now that a group company that acquired a non-deductible capital asset sells it to an unrelated trading company, whereafter the usufruct and bare dominium therein are acquired by other group companies. A consolidation system will not counter the scheme through the elimination of intra-group transactions, as none of the transactions in question will have been executed between group companies. However, it may direct the attention of the Receiver to the scheme, contributing to a potentially successful application of section 103(1). The reason is that a consolidation system requires the clear tabulation of group structures as a fundamental component of its operation. The focus in such a system therefore falls on the group as a whole (Cronje, n.d.(b): 10). If outside parties are involved in group tax schemes, clues to such schemes are not only fragmented across various group companies, but also across outside entities. The holistic view of groups brought about by a consolidation regime will more likely lead to a piecing together of such fragments by the tax authorities than a loss transfer regime.

It is possible to achieve a measure of group focus on the part of the tax authorities in the case of a loss transfer regime. For example, the transfer of losses between group members may be

monitored centrally by the assessor of the holding company of such a group. This may in turn lead to the centralised review of individual assessments. However, such central monitoring is not essential; the only intra-group coordination that is required in a loss transfer regime is in respect of loss transfers between group members that are parties to a particular transfer. Because an integrated group focus is therefore not essential for the operation of a loss transfer system, the achievement of such focus requires a certain degree of self-imposed discipline, which cannot merely be assumed as a given (Cronje, n.d.(b): 9). A consolidation system, on the other hand, demands a group focus by the very nature of its operation.

4.4.5 Conclusion as to revenue neutrality

The total amount of tax revenue is a function of the tax base, the intended tax burden and the efficiency of collection of that burden. A consolidation system is preferable to a loss transfer system as far as all three factors are concerned.

Because a consolidation system disregards all intra-group transactions for tax purposes and virtually eliminates the possibility of tax anomalies within a group context, it is less likely to influence the economic process. As commercial activity will therefore not be inhibited by tax considerations, economic well-being will be promoted, with a resultant increase in the tax base.

Both a consolidation system and a loss transfer system will reduce the intended tax burden through accelerated utilisation of historical as well as current assessed losses. With regard to historical losses, the impact may be particularly dramatic. However, it is possible to control and limit the impact by ring-fencing or closing off such losses. With regard to current assessed losses, the impact may not be as dramatic, because a significant number of current income transfer techniques that may be vulnerable probably go undetected by the tax authorities. The reduction in the intended tax burden due to the accelerated utilisation of assessed losses will be partially neutralised in a consolidation system through its disregard of intra-group transactions for purposes of taxation. In this way avoidance schemes based on the anomalous tax effects of certain inter-group transactions will be eliminated.

Not only will a consolidated system have a less negative impact on the intended tax burden than a loss transfer system, but it will also have a positive impact on the collection of that burden. This is achieved in various ways. Firstly, by reducing the number of assessments and transactions to be monitored and by focusing such monitoring on economically relevant transactions, the administrative burden on the tax authorities is eased, releasing resources for more effective policing. Secondly, non-election by qualifying groups in a consolidated system of group taxation will serve as a warning measure to tax authorities, indicating the possibility of intra-group arrangements that may be vulnerable to attack under the anti-avoidance provisions of the Act. Finally, the group focus required by a consolidated system may lead to the more effective detection of tax avoidance arrangements involving parties unrelated to groups, through the holistic consideration of fragmented clues to such arrangements.

When the combined effect of the tax base, the intended tax burden and the collection of that burden on the amount of tax revenues is considered, it becomes clear that the implementation of a consolidated group tax system will not dramatically affect revenue neutrality. It is even possible that a consolidated group tax system will be marginally revenue positive.

4.5 SIMPLICITY

4.5.1 Introduction

Simplicity refers to the ease of operation of a taxation system from a technical perspective. A group tax regime should preferably not contain complex requirements and procedures, particularly as the administrative capacity of the South African Revenue Service is severely stretched (Du Toit & Matthews, 1990: 9). If a system of group taxation is so complex that it is beyond the administrative abilities of the tax authorities, it clearly cannot be implemented, even if it will produce significant advantages in other respects. Furthermore, a system of group taxation should not be so complex as to result in a material increase in taxpayer resources committed to tax compliance.

Whichever system of group taxation is implemented, increased complexity will result from the introduction of additional legislative provisions to govern the group tax regime. Differences of opinion exist as to which system will entail the greater level of complexity and various arguments have been presented in this regard. For example, Matthews and Du Toit (1990: 25) state that a loss transfer system will require a greater amount of adaptation as the South African tax environment does not presently acknowledge the concept of transferring assessed losses between group companies. A consolidation system, on the other hand, will largely be the application of currently known concepts to different entities, namely groups instead of divisionalised companies. In contrast, Du Plessis (1995: 1) states that a consolidation system will result in considerable complexity due to the myriad of intra-group adjustments that will have to be made. Several other writers also express the opinion that a full consolidation system is far more complex than a loss transfer system. Further systematic analysis of the two systems is therefore necessary to resolve these conflicting opinions.

4.5.2 Loss transfer systems

A loss transfer system is widely perceived to be simpler than a consolidation system, as it does not require special treatment of intra-group transactions to render them tax irrelevant. In essence a loss transfer system acknowledges the group only to the extent that the assessed losses of one group company may be transferred to another group company. As such, taxpayers and tax authorities are not burdened with consolidation exercises involving entire group structures. The only group companies that have to be considered for group tax purposes are those companies that are parties to loss transfers. Furthermore, the only transactions that have to be considered for group tax purposes are particular loss transfers.

4.5.3 Consolidation systems

A consolidation system is more complex than a loss transfer system, the principal reason being that intra-group transactions are subjected to special tax treatment to neutralise their tax effects.

As far as the intra-group transfer of assets is concerned, two approaches can be followed to render such transfers tax irrelevant. The first approach involves initially recognizing the tax effects of such transfers, as if the transactions in question were concluded with outside parties, and to make certain year-end adjustments to eliminate their tax effects. The second approach involves the initial recording of intra-group asset transfers at values that will ensure tax irrelevance from the outset.

The two approaches can be illustrated through the example of intra-group stock transfers. Assume that Holdco manufactures trading stock at a cost of R100 and sells it to Subco, its wholly owned subsidiary, at a price of R200. At the end of the group's year of assessment, Subco has sold none of this stock. This means that the group has an unrealised profit of R100 in respect of stock transferred from Holdco to Subco, but not sold outside the group.

Under the first approach discussed above, the entire intra-group profit of R100 will be included in Holdco's taxable income upon the stock transfer. At the end of the year of assessment, however, Holdco's taxable income will be reduced by the unrealised profit of R100. This amount will be added back to Holdco's taxable income in the succeeding year of assessment.

Under the second approach, the transfer of stock from Holdco to Subco will be deemed to have occurred at its tax value in Holdco's hands. In other words, irrespective of the transfer price agreed by the two companies, the transfer price for tax purposes will be R100. Although this alternative will eliminate the need for year-end adjustments in respect of unrealised profits, and thereby reduce complexity, it will also result in the entire group profit accruing to Subco for tax purposes. This may cause problems in the instance where historical assessed losses of the individual group companies are ring-fenced, and Holdco has a considerable historical assessed loss while Subco does not. The group may decide to effect future sales of Holdco's products directly to outside parties, although this may not be the most efficient distribution method. Where historical losses are ring-fenced, the choice between the alternative approaches for dealing with unrealised profits will therefore be determined by the relative importance attached to simplicity and neutrality.

If historical assessed losses of individual companies are closed off while group tax treatment applies, the issue of neutrality will be irrelevant in deciding between the alternatives. As historical losses will not be available for set off against group income, the apportionment of profits between such companies for tax purposes will not matter. As neutrality will not be compromised in this instance, the second alternative will be the obvious choice due to its greater simplicity. However, the effective sterilisation of historical assessed losses while group tax treatment prevails may be considered unduly harsh.

With regard to the transfer of depreciable capital assets and financial instruments, it will be preferable for the sake of simplicity to deem such transfers to occur at their tax values. The complexity of the alternative consolidation approach will be realised when the example of an intra-group transfer of a capital asset at a tax loss is considered. The tax loss arising from the asset's transfer will have to be added back to taxable income during the year of the transfer. Furthermore, the tax allowances based on the transfer value will have to be adjusted upwards during each year in which the allowance is subsequently granted to reflect the tax value of the asset at the time of its transfer. Interestingly, a consolidation system deeming the intra-group transfer of depreciable assets to occur at their tax values will be much simpler to apply than the current anti-avoidance provisions in respect of the transfer of depreciable assets between connected persons.

Complex adjustments are not foreseen in respect of income/expenditure transactions between group companies, such as management fees, interest and rentals. One approach is to allow a deduction to one group member and include a corresponding amount in the gross income of the other member. With regard to the expenditure leg of income/expenditure transactions, the production of income requirement of section 11(a) and the trade requirement of section 23(g) should be applied in a group context to avoid the anomalies referred to in Chapter 2. However, if historical assessed losses of individual group companies are ring-fenced, this approach to income/expense transactions will necessitate anti-avoidance measures to oppose schemes aimed at the accelerated utilisation of assessed losses. Such anti-avoidance measures will produce increased complexity. An alternative approach is to deem the value of such transactions to be zero for tax purposes. However, this may lead to unreasonable results in circumstances where

historical assessed losses of individual group members are ring-fenced and the transactions in question are concluded for *bona fide* purposes and at market values.

From the above discussion it is clear that a consolidation system can be designed so as to eliminate the need for intricate year-end adjustments to neutralise the tax effects of intra-group transactions. By deeming transactions to occur at their tax values in the case of the transfer of assets or liabilities, or by deeming transactions to occur at no value in the case of income/expenditure transactions, they can be made tax neutral from the outset. When such an approach is followed, potential complexity will only arise from the identification and validation of intra-group transactions to which special values must be applied for consolidation purposes.

The identification of intra-group transactions is an issue that relates mainly to taxpayers, as groups will have to identify intra-group transactions when compiling consolidated returns. Because groups are required by the Companies Act to compile group financial statements in the preferred form of consolidated financial statements, most groups already have systems in place for the identification of intra-group transactions. These systems will require little, if any, modification to identify intra-group transactions for tax purposes.

The verification of intra-group transactions is an issue that relates mainly to tax authorities, as they will have to monitor the accuracy, completeness and validity of intra-group transactions in consolidated returns. The main difficulty that will be encountered in this regard is the verification of the completeness of intra-group transactions, as taxpayers may not disclose all such transactions in an attempt to illegitimately preserve intra-group tax avoidance schemes. However, the difficulty that may be encountered in verifying the completeness of intra-group transactions should not act as a deterrent in implementing a group tax regime - such verification is supposed to occur under the present regime to ensure the effective operation of sections 103(1) and 103(2) within a group context.

In any event, the tax authorities will receive considerable assistance from the auditors of group companies in monitoring the completeness of intra-group transactions. The reason can be found in AC 126 and SAAS 550 of the South African Institute of Chartered Accountants, which

respectively deal with the accounting requirements and the auditor's responsibility in relation to related parties and transactions with such parties.

Paragraph .06 of AC 126 states that parties are related if one party has the ability to control the other party or exercise significant influence over the other party in making financial and operating decisions (South African Institute of Chartered Accountants, 1997). Control is defined as ownership, directly or indirectly through subsidiaries, of more than one half of the voting power of an enterprise; or a substantial interest in the voting power and the power to direct, by statute or agreement, the financial and operating policies of the management of the enterprise. Under the above-mentioned definitions of related parties and control, companies that are members of closely held groups will be regarded as related parties.

Paragraph .23 of AC 126 determines that if there have been transactions between related parties, the reporting enterprise should disclose the nature of the related party relationships as well as the types of transactions and the elements necessary for an understanding of the financial statements. Paragraph .24 states that the elements of transactions necessary for an understanding of the financial statements would normally include an indication of the volume of the transactions, either as an amount or as an appropriate proportion; amounts or appropriate proportions of outstanding items and pricing policies. From these disclosure requirements, it can be seen that the schedules detailing intra-group transactions for tax purposes will merely be an adapted version of the working papers prepared when compiling the individual group companies' financial statements.

Paragraph 03 of SAAS 550 states that the auditor should perform procedures designed to obtain sufficient appropriate audit evidence regarding the identification and disclosure by management of related parties and the effect of related party transactions that are material to the financial statements (South African Institute of Chartered Accountants, 1997).

With regard to the existence and disclosure of related parties, paragraph 07 states that the auditor should review information provided by management identifying the names of all known related parties and should perform appropriate procedures to determine the completeness of this

information. Appropriate procedures according to the statement will include the review of prior year working papers for names of known related parties, the review of the entity's procedures for the identification of related parties, the review of shareholder records to determine the names of principal shareholders and the review of minutes of meetings of shareholders and the board of directors of the entity. Furthermore, paragraph 08 states that the auditor should satisfy himself that the disclosure of related party relationships in the financial statements is adequate.

With regard to transactions with related parties paragraph 09 states that the auditor should review information provided by the directors and management identifying related party transactions and should be alert to other material related party transactions. Paragraph 12 lists certain procedures that the auditor may employ to identify the existence of transactions with related parties such as performing detailed tests of transactions and balances, reviewing accounting records for large or unusual transactions or balances, reviewing confirmations of loans receivable and payable and confirmations from banks (such a review may indicate guarantor relationships and other related party transactions) and reviewing investment transactions. Furthermore, paragraph 16 states that the auditor should satisfy himself as to the proper disclosure of such material transactions with related parties.

Thus it is clear that a consolidation system of will not place a significant additional administrative burden on either groups or tax authorities. AC 126 already requires the disclosure of transactions with related parties in financial statements, while SAAS 550 obligates auditors to review the completeness of disclosure in financial statements of related parties and transactions with related parties. The verification of the completeness of intra-group transactions in consolidated statements will require a relatively simple reconciliation of the audited financial statements and supporting schedules with the consolidated return and supporting schedules.

4.6 CERTAINTY

Both the loss transfer system and the consolidation system will significantly diminish the present uncertainty concerning the legitimacy of transfer techniques between group members. No longer will such transfers be subject to the often vague and subjective provisions of sections 103(1) and 103(2). Instead, objective procedural rules will govern the transfer of losses between group members. These rules may be intricate and therefore complex, but they will lead to greater predictability of tax results.

However, a loss transfer system will not eliminate various uncertainties that currently exist with regard to the tax effects of various other intra-group transactions. A consolidation system, on the other hand, will prevent such uncertainties by treating intra-group transactions as tax irrelevant. Some of the uncertainties that have been more extensively discussed in Chapter 2 are as follows:

- uncertainty whether expenditure in respect of intra-group transactions satisfies the production of income requirement of section 11(a) and the trade requirement of section 23(g) with regard to the particular group company that incurs the expenditure (refer to sections 2.2.4, 2.3 and 2.4);
- uncertainty over the way in which expenditure should be apportioned in instances where inter-group expenditure is not wholly and exclusively laid out for the purposes of a particular group company's trade;
- uncertainty whether an amount received by or accrued to one group member, which is categorised as either revenue or capital in nature, will be similarly categorised in the hands of the group member who incurred the corresponding expenditure (refer to section 2.2.5);
- uncertainty whether interest on loans employed to finance the purchase of shares in another group company is incurred in the production of income derived from the purchaser's trade (refer to section 2.5);
- uncertainty whether losses on intra-group loans will be considered as capital or revenue in nature (refer to sections 2.6.3 and 2.6.4);
- uncertainty whether amounts paid in accordance with intra-group lease agreements will be categorised as lease premiums, resulting in asynchronous timing of accruals

and expenditure, or bullet rentals, resulting in synchronous timing of accruals and expenditure (refer to section 2.9);

- uncertainty whether transactions, operations or schemes executed to avoid unfavourable group tax anomalies or to exploit favourable group tax anomalies will overcome the hurdles of the rather general and vague section 103(1) (refer to section 2.13).

These uncertainties invariably lead to disputes between taxpayers and tax authorities that may deteriorate into costly and time-consuming litigation. Furthermore, in an attempt to deal with such uncertainties, highly skilled people with an in-depth knowledge of relevant court judgements must be employed by taxpayers as well as the tax authorities. These human resources can be more productively employed in expanding or improving economic production (in the case of taxpayers), or in more effectively monitoring transactions where tax relevance and economic relevance correspond (in the case of the tax authorities).

4.7 ADMINISTRATIVE COST

The administrative cost of a system of group taxation is intertwined with its effect on simplicity and certainty. Technical simplicity will lead to reduced compliance costs for taxpayers and monitoring costs for tax authorities. Greater certainty will lead to reduced consultation and litigation costs for both taxpayers and tax authorities.

In section 4.5 it was stated that consolidation systems are more complex than loss transfer systems mainly because of the special treatment of intra-group transactions to render them tax irrelevant. Nevertheless, consolidation systems can be designed to avoid much of the potential complexity. Furthermore, much of the infrastructure necessary for the identification and validation of intra-group transactions are already in place due to the requirements of AC 126 and SAAS 550.

In section 4.6 it was remarked that a consolidation system achieves greater certainty than a loss transfer system by treating intra-group transactions as tax irrelevant, thereby eliminating the need to predict the tax effects of intra-group transactions.

The fact that a consolidation system is more complex than a loss transfer system will result in increased compliance and control costs. On the other hand, by achieving greater certainty a consolidation system will result in reduced consultation and litigation costs. Consultation and litigation usually require more expertise and skill than compliance and control, and are therefore more expensive. A consolidation regime may therefore produce fewer administrative costs than a loss transfer system.

4.8 CONCLUSION

Chapter 4 demonstrated that a consolidation system of group taxation represents a more satisfactory trade-off between the various canons of taxation than a loss transfer system (and by implication, the current tax regime). It will achieve greater equity, neutrality, efficiency of collection and certainty. Furthermore, it may produce fewer administrative costs than a loss transfer system. In addition, a consolidation system should lead to a revenue neutral or a slightly revenue positive result because concessions are made to the taxpayer as well as the fiscus. A loss transfer system, on the other hand, makes concessions to taxpayers only by allowing the transfer of assessed losses between individual group companies without eliminating the potential for intra-group tax manipulation. The only disadvantage of a consolidation system is its technical complexity, but it is possible to design a system that will fall within the administrative capacity of the South African tax authorities. It will therefore be appropriate and desirable to introduce a consolidation system of group taxation into the South African tax environment.

5 AN EXAMINATION OF CERTAIN PROPOSALS OF THE KATZ COMMISSION WITH REGARD TO GROUP TAX

5.1 INTRODUCTION

The Third Interim Report of the Katz Commission addresses the issue of group taxation in some detail. The purpose of Chapter 5 is to examine certain recommendations made by the Commission in this regard.

5.2 IMPLEMENTATION OF A SYSTEM OF GROUP TAXATION

The Commission recommended the implementation of a group tax regime for South Africa in the form of a consolidation system. The following reasons were cited for the preference of a consolidation system over a loss transfer system (South Africa, 1995: 98 - 99):

- On a conceptual level a consolidation system recognizes the economic unity of a group to a greater extent than a loss transfer system.
- In a loss transfer system each company remains a separate taxpayer and much of the potential for manipulation of intra-group transactions remains, including the engineering of timing differences, manipulation of cost bases and exploitation of capital/revenue mismatches. A consolidation system prevents such manipulation by treating transactions between group members as tax irrelevant. A loss transfer system is therefore a system of “group relief” which benefits only taxpayers, as it allows the transfer of losses between group members without inhibiting intra-group manipulations. A consolidation system, on the other hand, represents a more acceptable trade-off between the interests of taxpayers and the fiscus.
- A consolidation system will improve efficiency of revenue collection in two ways. Firstly, as only transactions with outside parties are tax relevant, economic interests will serve to limit manipulations aimed at tax avoidance. Secondly, a consolidation system has the advantage that the full group’s results are presented to the Revenue in a single submission. This makes for an easy audit trail and resolves the problem that

information for different companies is seldom available when companies are assessed separately.

- Although it is sometimes contended that the consolidation system is a more complex alternative, this largely depends on the degree and manner of consolidation.

The writer concurs with the Commission's recommendation that a consolidation system should be implemented, as this will lead to a more satisfactory trade-off between the canons of taxation than either a loss transfer system or the present tax treatment of groups.

5.3 A GRADUAL APPROACH

5.3.1 Introduction

In Chapter 4 it was stated that a consolidation system might result in increased legislative complexity, but that this risk can be addressed during the design of the system. The Commission responded to the issue of complexity by proposing a gradual approach to the implementation of a consolidation system. The suggested initial system will not be a fully-fledged consolidation system, although it will be capable of growing in sophistication as those who participate in and administer the system gain experience of it (South Africa, 1995: 96). The writer is in agreement with such an approach, bearing in mind the limited resources currently available to the tax authorities.

The Commission proposed that when a full consolidation system is eventually implemented, the following principle, which is widely followed internationally, should apply. Upon the entry of a company into a group, any assessed loss of the acquired company is ring-fenced and may only be set off against the income from that specific company. Any unutilised assessed loss subsequent to entry into the group may be carried forward as a consolidated assessed loss and will be available for set off against the consolidated taxable income of the group in future years. The same principle should apply at the commencement of consolidated filing by a group (South Africa, 1995: 103).

In the simplified system proposed by the Commission, not only will initial assessed losses be ring-fenced, but also current assessed losses not fully utilised during the years of assessment in which they are incurred. In other words, any assessed loss incurred by a group company in a particular year of assessment may only be set off against income from another group company in that particular year (South Africa, 1995: 103).

Furthermore, the Commission did not envision the elimination of all intra-group transactions in the initial system. The only adjustments that will be included in such a system are those that will not result in undue complexity (South Africa, 1995: 103).

5.3.2 Proposed initial consolidation mechanism

The Commission proposed a consolidation mechanism consisting of four steps (South Africa, 1995: 103 - 105).

The first step would be to calculate the taxable income or assessed loss of each group member under the current tax regime. This calculation can be referred to as the sub-return. The sub-return should provide the information required in the standard corporate tax return as well as certain additional information on group-related transactions.

The second step would be to make adjustments in respect of certain intra-group transactions:

- Fixed assets transferred within a group should be deemed to be transferred at tax value and be subject to recoupment in the transferee up to the original cost of the assets to the group.
- There should be no allowances in terms of sections 24 or 24C in respect of intra-group transactions.
- There should be an adjustment to unrealised profits and losses on trading stock purchased from group members, which should be added back to taxable income in the following year of assessment.
- The provisions of section 23(g) should be applied in a group context.

The Commission also proposed further adjustments that may be introduced at a later stage. Examples of such adjustments include the following:

- adjustments for intra-group lease premiums and leasehold improvements;
- adjustments to group transactions involving capital revenue mismatches; and
- interest adjustments on intra-group loans governed by section 24J to the extent that there are mismatches.

The third step would be to add back the assessed loss that is brought forward from the previous year of assessment in the case of each sub-return. The consolidation for group tax purposes would be based on this notional figure.

The fourth and final step would be the determination of the consolidation results for each year of assessment. The Commission suggested the following simplified method:

- A company which has taxable income for the current year of assessment but has an assessed loss for the previous year will be obliged to contribute income into the consolidated return only to the extent that it can be absorbed by current year losses of one or more other companies in the group. If there are no such current year assessed losses within the group, the income of the company will be available for the set off of its assessed loss brought forward from the prior year.
- If an assessed loss balance remains after the procedure in the first bullet has been followed, it will be carried forward and will only be available for set off against income of that company's sub-return in the following year of assessment, once the procedure in the first bullet has been repeated.
- Any current year assessed loss of a company will first be set off against current year taxable income elsewhere in the group and, to the extent that it cannot be deducted, will be carried forward in that sub-return as an assessed loss which will be available for set off only against the income of that company's sub-return in the following year of assessment, once the procedure in the first bullet has been followed.
- If more than one company has a current year assessed loss, and the total current year assessed loss exceeds current year taxable income, a decision has to be made regarding which company or companies will carry forward assessed losses, and to

what extent. The Commission proposed that this decision should be left to the taxpayer.

From the above procedure it can be seen that there will initially be no consolidated assessed loss. Assessed losses, apart from current year losses utilised within the group, will be ring-fenced and will only be available for set off against specific group companies' income.

5.3.3 Comment on the proposed initial consolidation mechanism

The consolidation method proposed by the Commission goes some way in eliminating intra-group manipulations and allowing the utilisation of assessed losses within a group context, while simultaneously achieving a measure of simplicity. However, the writer disagrees with the specific approach followed in respect of adjustments for intra-group transactions, as well as the proposed treatment of entry and current losses.

5.3.3.1 Adjustments for intra-group transactions

The approach of the Commission with regard to consolidation adjustments appears to be that the taxable income of each company will be calculated in its separate sub-return without reference to the group tax regime, whereafter certain adjustments will be made to eliminate the tax effects of intra-group transactions. For example, it is proposed that unrealised profits on intra-group stock transfers should be eliminated, implying that such profits will be recognized in the sub-returns. However, it is proposed by the Commission that intra-group transfers of fixed assets should be deemed to occur at tax values. This implies an alternative approach, namely treating intra-group transactions from the outset in a manner that will not produce tax effects, thereby avoiding the need for later adjustments.

Nevertheless, when the group tax recommendations of the Commission are read in their entirety, it appears as if an approach is suggested where consolidation adjustments are made after sub-returns have been compiled wherein group companies are treated as separate taxpayers. This

approach is probably favoured to achieve a tidy transition from the existing basis on which taxable income of group companies is calculated. However, the fact that the tax effects of group transactions are firstly recognized and then eliminated through consolidation adjustments leads to unnecessary duplication and complexity. The Commission was probably influenced by the method followed in accounting to compile consolidated financial statements, where consolidated financial statements are derived from individual financial statements through accounting adjustments that eliminate the effects of intra-group transactions. This may be the most effective way to compile consolidated financial statements for accounting purposes, as separate financial statements for individual group companies are required by the Companies Act and must therefore be compiled in any event. On the other hand, separate returns in respect of individual group companies are not necessary for the purposes of group tax and the derivation of consolidated returns from separate sub-returns may therefore not be the most efficient approach.

An alternative approach to consolidation adjustments mentioned in Chapter 4 would be far simpler. According to this approach, each group company will still compile its own sub-return, but special rules will apply for recording the number of intra-group transactions to prevent resulting tax effects. For example, the intra-group transfer of assets and liabilities such as trading stock, plant, machinery and financial instruments should be deemed to occur at their tax values. Furthermore, intra-group income/expense transactions such as management fees, interest, royalties and lease premiums should be deemed to occur at nil value. If such an approach is followed, more intra-group transactions can be addressed by the consolidation system during its initial implementation without unduly complicating the system. It will not be necessary, for example, to postpone adjustments concerning intra-group lease premiums, intra-group leasehold improvements and the intra-group transfer of financial instruments, because the neutralisation of such transactions under the alternative approach would be relatively simple.

It is important that all intra-group transactions are addressed by the consolidation system as quickly as possible. The sooner this is done, the sooner maximum compliance with the canons of taxation will be achieved. The approach to consolidation adjustments suggested in this work will contribute to the speedy implementation of a fully-fledged consolidation system by simplifying the elimination of tax effects in respect of intra-group transactions.

5.3.3.2 The treatment of entry losses and current losses

With regard to entry losses the writer is of the opinion that they should initially be closed off completely instead of being ring-fenced for utilisation against the income of the particular group companies to which they pertain. With regard to current assessed losses the writer is of the opinion that no ring-fencing should occur and that a consolidated assessed loss should be created for set off against future consolidated income.

The ring-fencing of entry and current assessed losses will encourage taxpayers to effect schemes whereby income is transferred from profitable group members to group members with ring-fenced assessed losses. Increased complexity will result in two ways. Firstly, anti-avoidance measures will be necessary to address such transfers by requiring that all intra-group transactions should be conducted on an arm's length basis or by applying the provisions of section 103 to such transactions. Both of these alternatives will be difficult to apply in practice. Secondly, it will be necessary to keep track of ring-fenced assessed losses of individual group companies, resulting in more detailed record keeping.

The sterilisation of entry losses while group tax treatment applies to a group may appear harsh. Yet such a measure can be justified in the light of the following arguments:

- Simplicity is a fundamental condition for the initial implementation of a group tax regime. When the other tax benefits which groups will obtain are considered, the closing off of entry losses may be considered as an acceptable sacrifice.
- Although entry losses will be sterilised for the duration of group tax treatment, current losses will be available for set off against consolidated income without restriction. This represents a more satisfactory trade-off from a conceptual perspective, as the economic unity of the group will at least be fully recognized concerning current losses. This will not be the case where current losses are ring-fenced.
- Closed off entry losses can be made available to a particular group company once it exits the group. Such losses will therefore not be permanently sterilised.
- The sterilisation of entry losses will only be a transitional measure. Once the impact of the initial consolidation system on revenue collection can be more accurately

assessed, entry assessed losses can be gradually phased in for utilisation against consolidated income.

- Qualifying groups will be able to elect group tax treatment under the system proposed by the Commission. If a group considers the sterilisation of entry assessed losses to be unduly harsh, it can simply refrain from electing group tax treatment.

5.4 CONCLUSION

The Katz Commission recommended the implementation of a consolidation system of group tax in South Africa. Although such a system represents a more satisfactory trade-off between the canons of taxation than either a loss transfer system or the present tax regime with regard to groups, the Commission recognized that a consolidation system may lead to unacceptable complexity. A gradual approach to implementation was therefore suggested, with the initial system being relatively simple but capable of future refinement. The initial consolidation mechanism proposed by the Commission, with the modifications suggested in this chapter, will contribute to increased equity, neutrality and certainty, and lead to reduced administrative costs without being unmanageably complex.

6 SUMMARY AND CONCLUSION

In Chapter 1 the concept of groups was examined, the purpose of a group tax regime was explained and different systems of group taxation were described. Furthermore, the canons of taxation, which would serve as a tool for evaluation of the present tax treatment of groups and alternative systems of group taxation, were discussed.

In Chapter 2 the present tax treatment of groups was examined by focusing on the tax effects of various intra-group transactions. It was concluded that the present tax treatment of groups does not promote equity, neutrality, low administrative cost and certainty. And although the absence of statutory provisions dealing explicitly with group taxation contributes to legislative simplicity, it simultaneously leads to complex tax-driven schemes aimed at exploiting favourable tax anomalies and avoiding unfavourable tax anomalies.

In Chapter 3 certain issues were considered which might render a system of group taxation unnecessary or undesirable, even if such a system produces a more satisfactory trade off between the canons of taxation. None of these issues was found to have such an effect. With regard to divisionalisation as a possible substitute for a system of group taxation, it was concluded that section 39 of the Tax Laws Amendment Act (1994) does not establish an accessible tool for the divisionalisation of existing groups. In addition, there are various commercial and legal reasons why groups may be preferred over divisionalised companies. Concerning the limited liability enjoyed by individual group companies, a benefit which is unavailable to divisions of a single company, it was found that groups rarely abuse or even legitimately utilise this privilege in practice. Furthermore, a system of group taxation will complement the concept of limited liability in promoting economic growth. Finally, it was concluded that a group tax regime will not encourage further concentration of economic control, as the intra-group shareholding required for group tax treatment will be far greater than the shareholding required for control. It was also found that a group tax regime may reduce the concentration of economic ownership by facilitating direct outside shareholdings in business enterprises which would otherwise have been structured as divisions.

In Chapter 4 consolidation systems were compared with loss transfer systems, employing the canons of taxation as a theoretical framework. Because a loss transfer system is very similar to the present tax treatment of groups, in the sense that both systems treat individual group companies as separate taxable entities, the present tax regime with regard to groups was implicitly included in the comparison. A consolidation system of group taxation was recommended for South Africa as it represents the most satisfactory trade-off between the various canons of taxation. A consolidation system will lead to the greatest level of equity, neutrality, efficiency and certainty, while it will contribute to lower administration costs, both for taxpayers and the fiscus. Although a consolidation system carries the risk of complexity, it is possible to design and implement a specific system in such a way that it will not be unmanageable.

In Chapter 5 certain key recommendations of the Katz Commission with regard to group taxation were investigated. The writer expressed his agreement with the Commission's proposal for the gradual implementation of a consolidation system. Certain modifications to the proposed system were suggested to further reduce its complexity and accelerate full implementation.

When the anomalies of the present tax treatment of groups are considered, it becomes evident that the *status quo* is untenable. From both a theoretical and practical perspective, the implementation of a consolidation system of group taxation will represent a significant structural improvement to the South African tax regime.

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 Turnbull v CIR (1953 (2) SA 573 (A), 18 SATC 336)
 Van Leer Packaging (Rhodesia) (Pvt.) Ltd. v COT (1970 (1) SA 594, 33 SATC 19 RAD))